No. 73-1701

IN THE

Supreme Court of the United States

OCTOBER TERM, 1974

UNITED STATES OF AMERICA, *Appellant*

v.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., ET AL., *Appellee*

On Appeal From the United States District Court For the District of Columbia

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BRIEF OF APPELLEE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

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This is an appeal from a judgment dismissing a complaint which alleges violations of the Sherman Act in connection with the sale of securities of open-end management investment companies or mutual funds as they are called. The National Association of Securities Dealers, Inc. ("the NASD") was named as a defendant in the count of the complaint alleging a conspiracy and combination.

STATUTES INVOLVED

Pertinent provisions of Section 15A of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3, and of Section 22 of the Investment Company Act, 15 U.S.C. 80a-22, are set out in Appendix A and Appendix B hereto, respectively.

QUESTION PRESENTED

Whether the Sherman Act reaches the hereinvolved activities of the NASD which relate to the primary distribution of mutual fund shares, and which are subject to a comprehensive statutory pattern of regulation and pervasive oversight by the Securities and Exchange Commission (1) under the Maloney Act that embodies its own measures for dealing with anticompetitive practices and provides for antitrust immunity, and (2) under the Investment Company Act that relies upon regulation rather than competition for determining sales charges to investors in the sale of mutual fund shares.

STATEMENT

The NASD is a creature of Section 15A of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3, the so-called Maloney Act of 1938. It has regulatory responsibilities over the over-the-counter markets generally. In addition, the Investment Company Act of 1940, 15 U.S.C. 80a-1, *et. seq.*, vested the NASD with authority in connection with the pricing and sales charges for shares of mutual funds. The NASD currently has approximately 3200 members of whom about half are primarily engaged in the sale of mutual fund securities.[1]

A. The Maloney Act

The Maloney Act supplements the regulation of the over-the-counter markets by the Securities and Exchange Commission ("the Commission"). It provides a system of co-operative regulation of over-the-counter markets through voluntary associations of brokers and dealers. To spur membership, Section 15A (i) (1) provides that the rules of an association may provide that no member shall deal with

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[1] References will be made to pages of appellant's brief as "Br. " and to the Joint Appendix as "J.A. ". Italics appearing in quotations are not in the original and have been added.

a non-member except on the same terms, including price, as such member accords the general public. Section 25 of the NASD Rules of Fair Practice so provides.

The NASD is the only national securities association registered under Section 15A.[2] As such it is subject to a reticulated pattern of statutory regulation as well as comprehensive and continuous supervision by the Securities and Exchange Commission. For example, the rules of the NASD must satisfy prescribed statutory standards that, *inter alia,* deal with anti-competitive practices, and provision is made for antitrust immunity. Thus, Section 15A embodies an accommodation of the policies of the securities laws and those of the antitrust laws.

To qualify for registration, a national securities association must, under Section 15(A) (e), satisfy the detailed requirements of Section 15A. These requirements are cast primarily in terms of what an association's rules must provide.

Section 15A (b) (8) is the focal point of the Maloney Act. It ". . . outlines the functions for the accomplishment of which registered securities associations are expected to accept responsibility."[3] This section provides:

> "An applicant association shall not be registered as a national securities association unless it appears to the Commission that—
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> * * *
>
> "(8) the rules of the association are designed to prevent fradulent and manipulative acts and practices, to promote just and equitable principles of trade, to

[2] The NASD, which was incorporated in Delaware on July 18, 1939, became registered under Section 15A of the Securities Exchange Act on August 7, 1939. *National Association of Securities Dealers, Inc.*, 5 S.E.C. 627 (1939).

[3] S. Rep. No. 1455, p. 7, H. Rep. No. 2307, p. 7, both accompanying S.3255, 75th Cong. 3d Sess. (1938) which contains Section 15A. The provision was then Section 15A (b) (7); it was renumbered as a result of other amendments in 1964.

provide safeguards against unreasonable profits or unreasonable rates of commission or other charges, and, in general, to protect investors and the public interest, and *to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers,* to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges."

Section 15A contains a web of provisions to assure Commission jurisdiction and continuous supervision of the rules of an association. Section 15A establishes the Commission as the forum for treating with these rules. Thus, as already pointed out, under Section 15A (e), an association may not be registered unless the Commission is satisfied that the association has adopted rules required by Section 15A. Next, under Section 15A (j), any change in or addition to an association's rules does not become effective until the Commission is afforded an opportunity for scrutiny, and the Commission is obligated to disapprove a change or addition unless it is "consistent with the requirements" of Section 15A (b). Furthermore, Section 15A (k) (1) authorizes the Commission to abrogate an existing association rule "where necessary or appropriate to assure fair dealing by the members of such association . . . or otherwise to protect investors or to effectuate the purposes of this title."[4] The Commission is also authorized under Section 15A (k) (2) to alter or supplement association rules in certain areas. Again, under Section 15A (h) (1), which provides for Commission review of disciplinary action taken by an association, the Commission must consider the application and interpretation of the association's rules that are involved.

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[4] The Commission has invoked this authority to abrogate an interpretation by the NASD of one of its rules. *National Association of Securities Dealers, Inc.,* Securities Exchange Act Release No. 9682 (June 7, 1972), *aff'd, N.A.S.D.* v. *S.E.C.,* 486 F. 2d 1314 (C.A.D.C.).

Other provisions of Section 15A, many of which also include rulemaking power, relate to scope of membership and character of the association[5]; disqualifications for membership[6]; training and experience of members and their associates[7]; representation and dues[8]; association disciplinary action against members and their associates,[9] and Commission review thereof[10]; withdrawal of an association from registration[11]; affiliated securities associations (of which there are none)[12]; and Commission disciplinary action against members or their associates, and against the association itself as well as its management.[13]

Finally, as the Commission has stated, since "Congress obviously did not intend to subject the NASD to liability under the antitrust laws for performing a function authorized by statute",[14] Section 15A (n) provides:

> "If any provision of this section is in conflict with any provision of any law of the United States in force on

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[5] Section 15A (b) (1), (2), and (3), 15 U.S.C. 78o-3 (b) (1), (2) and (3).

[6] Section 15A (b) (3) and (4), 15 U.S.C. §78o-3 (b) (3) and (4).

[7] Section 15A (b) (5), 15 U.S.C. §78o-3 (b) (5).

[8] Section 15A (b) (6) and (7), 15 U.S.C. §78o-3 (b) (6) and (7).

[9] Section 15A (b) (9) and (10), 15 U.S.C. §78o-3 (b) (9) and 10.

[10] Section 15A (g) and (h), 15 U.S.C. §78o-3 (g) and (h).

[11] Section 15A (f), 15 U.S.C. §78o-3 (f).

[12] Section 15A (c) and 15A (b) (11), 15 U.S.C. §78o-3 (c) and (b) (11).

[13] Section 15A (l), 15 U.S.C. §78o-3 (l).

[14] 1967 Senate Hearings, note 51, *infra*, at p. 123.

> the date this section takes effect, the provision of this section shall prevail."[15]

In addition, as discussed below, the Investment Company Act grants an association rule making power in connection with the pricing and sales charges for mutual fund shares. This power, in addition to meeting the applicable standards of that statute, must be exercised in accordance with and subject to Section 15A.[16]

B. The Investment Company Act and the Sale of Mutual Fund Shares

The Act provides for thoroughgoing regulation of all aspects of the activities and operations of all types of investment companies. Section 22, *inter alia*, deals specifically with the sale and redemption of mutual fund shares.

A mutual fund is essentially a managed portfolio of securities. It is characterized by the fact that it issues a redeemable common stock under an obligation to pay the holder his proportionate share of the market value of the fund's net assets.[17] In effect, this redemption right provides

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[15] In *United States* v. *Socony-Vacuum Oil Co.*, 310 U.S. 150, 227, n. 60 (1950), this Court stated:

> ". . . [T]he typical method adopted by Congress when it has lifted the ban of the Sherman Act is the scrutiny and approval of the designated public representatives . . . And see the Maloney Act (§15A of the Securities Exchange Act of 1934; 52 Stat. 1070) providing for the formation of associations of brokers and dealers with the approval of the Securities and Exchange Commission and establishing continuous supervision by the Commission over specified activities of such associations."

See also *International Association of Machinists* v. *Street*, 367 U.S. 740, 809-10, n. 16 (dissenting opinion).

[16] See note 36, *infra*.

[17] Sections 2 (a) (32), 5 (a) (1) and 22 (e) of the Act, 15 U.S.C. 80a-2 (a) (32), 5 (a) (1) and 22 (e).

a ready "market" for a selling shareholder.[18] Because of the redeemability feature, mutual funds generally make a continuous offering or a primary distribution of their common stock in order to prevent their assets from shrinking. The offering price per share, which is described in the fund's prospectus, consists of the net asset value per share, which is computed at least once a day, plus a sales charge or "sales load"[19] fixed by the principal underwriter in the case of the type of funds here under consideration.

Section 22 embodies a unique regulatory pattern that encompasses the price at which mutual fund shares are to be sold both in the primary distribution and thereafter. It is based on the Maloney Act's design of cooperative regulation. As more fully described below, Section 22 authorizes the NASD to adopt rules relating to the computation of the net asset value and sales load components making up the public offering price. These rules must be passed upon by the Commission. Provision is made for antitrust immunity. The Commission exercises continuing oversight with respect to the NASD rules. It may alter or supplement NASD rules and also adopt its own rules, which may supersede NASD rules. The public offering price described in the prospectus is sustained by a statutory retail price maintenance provision.

To implement Section 22, the NASD has adopted one rule specifically dealing with mutual funds, Section 26 of its Rules of Fair Practice, pertinent text of which is set forth in Appendix C. The rule relates to the primary distribution and redemption of mutual fund shares. The rule and its amendments have been passed upon by the Com-

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[18] *United States* v. *Cartwright,* 411 U.S. 546, 549, 557.

[19] Section 2 (a) (35) of the Act, 15 U.S.C. 80a-2 (a) (35).

mission and tested against the applicable standards of Section 22 and Section 15A (b) (8) of the Maloney Act.[20]

The primary distribution by which mutual funds sell their shares to investors has been basically as follows, both before and since the passage of the Act: The mutual fund by contract grants the exclusive right to purchase shares from the fund to a principal underwriter, who generally acts only as a wholesaler, and leaves the retailing to dealers, who enter into a sales agreement with the underwriter. The underwriter may enter into contracts with hundreds of dealers; dealers, in turn, may enter into sales agreements with any number of underwriters. The principal underwriter and the retail dealer divide the sales load component included in the public offering price, and the mutual fund receives the net asset value.

Underwriting and dealer agreements have always been part of the conventional process for distributing securities generally. One important ingredient of these contracts are provisions intended to provide assurance that the participants will protect the distribution and maintain the public offering price. The distribution of mutual fund shares under the Act was tailored to this format. Section 22 (d) of the Act, for reasons stated below, extended the obligation of maintaining the public offering price described in

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[20] In passing initially upon the rule, the Commission described its function, which applies as well to rule amendments, as follows:

> "The questions before us, therefore, are not only whether there is statutory authority [under Section 22 of the Investment Company Act] for the proposed amendment, but also, if such authority exists, whether the amendment is 'consistent with the requirements of subsection (b)' of Section 15A. If the proposed rule lacks statutory authorization, or if it cannot be reconciled with the provisions of subsection (b) (7) [now (8)] of Section 15A, it is our *duty* under Section 15A (j) to disapprove it". *National Association of Securities Dealers, Inc.* 9 S.E.C. 38, 40 (1941).

a fund's prospectus even to those who were not contractually bound and who had been engaging in a secondary market in outstanding shares and undercutting the public offering price. The Act created "a sheltered, price protected market for merchandisers of fund shares", as the Commission has observed.[21]

As discussed below, because of Section 22 (d), as well as independent economic reasons, the secondary market in mutual fund shares is now sharply diminished. This market, both before and after the passage of the Act, has involved a dealer acting as a principal. There has never been a brokerage market. The Commission, however, as discussed below, in November 1974 announced a proposal looking to the introduction of a brokerage market on a circumscribed basis and with special features necessitated by the peculiarities of mutual fund share distribution and the expressed Congressional policy of not impairing that system. Proceeding from the statutory theme of cooperative regulation, the Commission has enlisted the assistance of the NASD in this connection.

The above described features of mutual fund shares and of the statutory framework has led the Commission to characterize the shares as "a peculiar type of security", and to observe:

> "The nature of these shares and the manner in which they are distributed and redeemed are so extraordinary as perhaps to justify extraordinary treatment."

and then to point out:

> "It is reasonably apparent that, when the clause of Section 15A regarding a free and open market was adopted by the Congress, the legislators were addressing themselves to the market for more traditional types

[21] 1966 Commission Report referred to at p. 32, *infra*, at p. 56.

of securities and did not have in mind the peculiarities of open-end investment company shares."[22]

SUMMARY OF ARGUMENT

One count of the complaint alleges that the NASD and its members have, in violation of the Sherman Act, combined to prevent the growth of a secondary market in mutual fund shares. In naming the NASD, appellant suffered from basic misconceptions, and as a result it has repudiated the keystone of its complaint, that the NASD established and maintained rules that inhibited the development of secondary dealer and brokerage markets. Appellant now recognizes that the NASD rules apply only to the primary distribution of mutual fund shares, that they do not prohibit secondary market transactions, and that while the rules require a sales agreement, they do not require it to contain provisions restricting the operations of a secondary market. Rather than acknowledge its misadventure, appellant endeavors to salvage its complaint by referring to a 15 year old letter the NASD sent to its members as to which appellant takes contradictory positions. The letter is irrelevant because it dealt with the primary distribution of mutual fund shares emanating from the issuer, and *not* the secondary market in outstanding shares that had been distributed to investors.

Appellant, enlarging upon a Commission interpretation, seeks to create a dichotomy between the Investment Company Act and the antitrust laws for one segment of mutual fund sales charges, i.e., in transactions between investors which involve a dealer acting only as a broker. Otherwise,

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[22] *National Association of Securities Dealers, Inc.* 9 S.E.C. 38, 45, 46 (1941). The Commission made the above comments in rejecting arguments by non-contract dealers that one of the redemption provisions of Section 26 of the NASD Rules of Fair Practice impeded a free and open market and created unfair discrimination.

appellant acknowledges that the sales charges to investors in *all* mutual fund share transactions, whether in the primary distribution or in the secondary market, are governed exclusively by the regulatory pattern of the Investment Company Act.

The Investment Company Act, by providing for retail price maintenance and accepting contractual restrictions, is designed to protect the primary distribution system, including its fixed sales charges, from the price competition of the secondary market. Section 22 (d), which was proposed by the mutual fund industry, extended the obligation of retail price maintenance to non-contract dealers, who had been able to undercut the public offering price in their trading in outstanding shares, thereby causing defections in the ranks of the competitively disadvantaged contract dealers. Appellant does not accept this statutory purpose, although the Commission has viewed it as such over the years, and the Congress reaffirmed this purpose when it reenacted Section 22 (d) in enacting the 1970 amendments to the Act, a subject which appellant wholly ignores.

The question of sales charges, the issue in this case, was a focal point of those amendments, which were preceded by a Commission report that had concluded that sales charges should be lowered. The Congress at great length reviewed the matter, including the absence of competition and of a secondary market for mutual fund shares. Section 22 (d) was referred to repeatedly as providing an exemption from the antitrust laws. The matter of sales charges was approached as not being within the ambit of those laws. The Congress rejected the Commission's proposal for a statutory ceiling on sales charges. Next, because of a concern, *inter alia,* with the adverse effects of a competitive secondary market on the primary distribution system and on the funds themselves, it rejected the repeal of Section 22 (d), which would have revived the secondary market and provided

competition in sales charges. The advocates of repeal included appellant. The Congress decided to leave the regulation of sales charges as it was, under the aegis of the NASD and Commission, but to prescribe new statutory standards in place of the then existing standard, which was found wanting.

The Commission was instructed to make a study of the consequences of price competition if Section 22 (d) were repealed. After a study and hearings, the Commission, on November 4, 1974, released a report of its staff that included a recommendation for the matching of buy and sell orders, on an agency basis, in a secondary market at competitively determined prices and commission rates. To implement the recommendation, the Commission has requested the NASD to amend its rules to prohibit agreements that restrict the matching of orders, recognizing at the same time that the NASD rules do not require such restrictions.

In recognition of the statutory policy, which appellant rejects, the Commission is not proposing a conventional brokerage market. It will impose certain conditions to help to neutralize any adverse impact of these proposed brokerage transactions on the primary distribution system. For example, funds will be permitted to introduce a novel transfer charge, part of which may be paid to the underwriter for promotional efforts, and there will be special trading restrictions. The Commission's action proceeds from the premise of the propriety, as well as its regulatory authority over, contractual restrictions in sales agreements, and reflects its judgment that the statutory policy does not permit the flat termination of contractual restrictions dictated by the different policy of the antitrust laws, as appellant urges, but compels regulatory intercession and oversight. The matter at hand, therefore, is not one for resolution under the antitrust laws.

ARGUMENT

I. THE MISCONCEIVED COMPLAINT AGAINST THE NASD

The NASD is named only in Count 1 of the complaint. That count alleges that the NASD and its members have, in violation of Section 1 of the Sherman Act, 15 U.S.C.1, combined to prevent the growth of a secondary market in mutual fund shares. The contractual restrictions as to the secondary market, which form the basis of the other counts in the complaint, are not required by the NASD, either by its rules or otherwise.

In naming the NASD, appellant labored under basic misconceptions. The complaint mounted a broadside attack on the NASD rules. This was the keystone. Thus, the complaint (¶17, J.A. 9) alleges that to effectuate the alleged combination and conspiracy the NASD

> "(a) established and maintained rules which inhibited the development of a secondary dealer market and a brokerage market in mutual fund shares;
> "(b) established and maintained rules which induced broker/dealers to enter into sales agreements with principal underwriters, with knowledge that sales agreements contained restrictive provisions which inhibited the development of a secondary dealer market and brokerage market in mutual fund shares;"

In its memorandum and reply in support of its motion to dismiss filed in the court below, the NASD, on the basis of the statutory plan described herein previously, pointed out: (1) that under the Maloney Act, the forum for an attack on NASD rules was not the court but rather the Commission, which had exclusive jurisdiction of the matter, (2) that like all its rules, the one NASD rule—Section 26 of the NASD Rules of Fair Practice—dealing with the distribution of mutual fund shares, had been specifically passed upon by the Commission under the Maloney Act, and also

the Investment Company Act, and (3) that the NASD rules enjoyed antitrust immunity. Furthermore, the NASD reviewed in detail the aforementioned Section 26, which made it clear that there was no warrant for appellant's allegations.

Confronted with these considerations, at the oral argument below, appellant made a hasty retreat and repudiated the foregoing allegations. It was announced, as it later confirmed by letter to the court, that the complaint was not attacking any NASD rules.[23]

Appellant still finds itself in this anamolous posture. It states (Br. 51, note 47) that it is not challenging the validity of the NASD rules, the heart of its complaint. Indeed it is compelled to acknowledge that the NASD rules "apply only to the primary distribution of mutual fund shares" (Br. 51, note 47), that they do "not prohibit secondary market transactions" (Br. 49), and that while Section "26 requires sales agreements, it does not require them to contain provisions restricting the operations of a secondary

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[23] Following oral argument, the court below invited the Commission to participate in the case. The Commission advised the court by letter that it would likely participate if appellant were attacking the NASD rules, "over which the Commission is granted exclusive original jurisdiction by Section 15A of the Securities Exchange Act of 1934" (J.A. 323) and that if this litigation does "in fact constitute attacks on matters which are within the Commission's supervisory jurisdiction over NASD rules then the teaching of *Ricci* [v. *Chicago Mercantile Exchange,* 409 U.S. 289, 302-303n.13] and the very structure of the Maloney Act require you to conclude that these cases cannot be maintained under the antitrust laws" (J.A. 325-326), pointing out in this connection that Section 15A (n) provides an "express antitrust exemption" (J.A. 326, note 5). Letter of August 9, 1973, from Lawrence E. Nerheim the Commission's general counsel (J.A. 323). In response, appellant advised the court by letter of August 20, 1973 that it was not attacking the NASD rules (J.A. 327).

market" (Br. 48).[24] As appellant has now learned, Section 26 of the NASD Rules of Fair Practice deals with the primary distribution of mutual fund shares from their issuers, through the intermediary underwriters and dealers, to the ultimate investors.[25]

Reflecting more of this misconception, the complaint alleges that to further the conspiracy the NASD

> "discouraged persons who made inquiry about the legality of a brokerage market from participating in a brokerage market and distributed misleading information to its members concerning the legality of a brokerage market in mutual fund shares;" (J.A. 9).

Appellant now disengages itself from this allegation. Having learned the facts from the NASD presentation below, it now points to and embraces (Br. 41; 61, note 54) the NASD manual to its members. This manual has stated for many years, on the basis of a Commission staff opinion which will be discussed later, that a brokerage transaction at less than the public offering price solely between investors is not prohibited by virtue of Section 22 (d) of the Investment Company Act. Appellant also cites letters from the NASD for the same proposition (Br. 41). It could

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[24] The relief requested also reflects appellant's intended attack on the NASD rules and is predicated on misconception. The prayer of the complaint is cast in terms of enjoining the NASD from "establishing, maintaining or adhering to any rule . . ." etc. (J.A. 19) This contradicts the rule making procedures and Commission jurisdiction as contemplated by the Maloney Act and the Investment Company Act discussed earlier.

[25] Again, now that it has learned the facts, appellant acknowledges (Br. 51, note 47) that the NASD rules do not fix prices. Its complaint, however, would enjoin the NASD from fixing the price for a brokerage transaction (J.A. 19).

find even more. See, e.g., *What You Must Know* (1964), p. 57, an NASD pamphlet dealing with mutual funds.[26]

Faced with a complaint rent by its own concessions, appellant seeks to salvage its case by reaching back 15 years to cull out, from the reams of material that had been submitted to it by the NASD long before the filing of the complaint, an isolated letter of June 22, 1959, from the NASD to its members. It is this letter alone that appellant has in mind when it speaks of "unofficial interpretations and extensions of rules to restrict secondary markets" (Br. 51, note 47, citing GX-6, 14-19, J.A. 251, 268-280), and which is the fuel for the repeated references in its brief to collusion, combination, collective action, etc.[27]

The June 22, 1959 letter (GX-18, J.A. 278), however, is irrelevant to this action because it dealt with the primary distribution of shares by the issuer, as will be shown below. Moreover, appellant's own position as to the letter is contradictory. It acknowledges in effect that the letter did not restrict the secondary market. Then, in utter disregard of this concession, it makes arguments about the letter, which however camouflaged, are a challenge to Section 26 of the NASD Rules of Fair Practice, notwithstanding appellant's assurance that the complaint does not "seek to overturn any NASD rule" (Br. 51).

The letter dealt with the primary distribution of shares emanating from the issuer, and *not* the secondary market in previously issued and outstanding shares. Even under appellant's specially tailored concepts (Br. 7, note 6), it must acknowledge that the subject of the letter was the primary distribution of shares from the issuer. Contrary to

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[26] The complaint would require the NASD to include in its manual the references to brokerage transactions (J.A. 19) that appellant now acknowledges are already there.

[27] Appellant filed some 30 exhibits below. It has presented its case. The NASD submitted no evidence.

appellant's intimations (Br. 61), the letter had absolutely nothing to do with the secondary brokerage market. Nor did it deal with a purchase from an investor who might be the potential beneficiary of a price advantage in the secondary dealer market, the *raison d'etre* for that market's espousal by appellant (Br. 10). The letter dealt with non-contract dealers participating in a primary distribution of shares to investors. It did not affect the price paid by the investor. Under Section 22 (d) of the Investment Company Act, as appellant recognizes (Br. 9), such non-contract dealers must sell to an investor at the public offering price.

The letter dealt with the situation of contract dealers who took down shares from the underwriter to fill orders—at a discount from the public offering price—from non-contract dealers. As indicated in the letter, this practice permitted a non-contract dealer to evade the intent of Section 26 (c) of the NASD Rules of Fair Practice, which requires that a dealer in the primary distribution have a contract with the underwriter, and of Section 26 (f) (2), which permits a dealer to take down shares from the underwriter only to cover orders he has already received.[28] The letter

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[28] Section 26 (c) "requires a sales agreement, between the underwriter and any dealer interested in primary distribution . . .", as the NASD explained to the Commission when it considered the rule before its adoption. Public Conference on a Proposed Amendment to the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (1941), p. 8 ("1941 Public Conference"). The Commission in passing upon the rule pointed out:

> "The primary distribution of the shares of open-end investment companies is customarily made through underwriters and dealers having sales agreements with the issuer or principal underwriter. Paragraph (c) . . . in effect requires such an agreement by providing that a member of the Association who is a principal underwriter may not sell to another member at a concession from the public offering price unless a sales agreement is in effect between the parties".

(Footnote continued on next page)

stated that the situation to which it was addressed may be corrected through amendment of sales agreements.[20].

Appellant takes contradictory positions with respect to the letter. It states: "While Rule 26 requires sales agreements, it does not require them to contain provisions restricting the operations of a secondary market" (Br. 48). The fair implication of this statement is that appellant finds no fault with the requirement of Section 26 (c) that a dealer participating in a primary distribution have a sales agreement with the underwriter. The June 22, 1959, letter simply sought to prevent the circumvention of this requirement, which appellant in the above quotation accepts as

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(Footnote continued from preceding page)

National Association of Securities Dealers, Inc., 9 S.E.C. 38, 44 (1941).

Section 26 (f) (2) prohibits a member (other than a dealer buying for his own investment) from purchasing shares from the issuer or underwriter "except for the purpose of covering purchase orders already received." The purpose of Section 26 (f) was "to eliminate any extra undisclosed profits by dealers and underwriters at the expense of the issuers and/or investors", as the NASD explained at the Commission hearing on the rule before it became effective. 1941 Public Conference, pp. 9-10. If Section 26 (f) were not construed as referring to orders received from the public, non-contract dealers who purchased through the contract dealer could "inventory" the shares and derive profits at the expense of the existing security holders, which Section 26 (f) was intended to deny.

[20] The amendment would have been to the effect that shares (other than for bona fide investment by the dealer) may be taken down at a discount only to fill orders in hand from members of the public. This is a common provision in agreements. The letter further pointed out that strict enforcement of selling group agreements will also serve to remedy the situation.

It is interesting to note that an NASD letter (GX-22) submitted by appellant states that if a non-contract dealer "is not willing to arrange for a selling agreement . . . the most practical course . . . is to obtain the shares in the open market . . ." (J.A. 290). Such advice hardly comports with the scenario appellant has composed and the role it assigns to the NASD as an instrument for inhibiting the secondary market.

not "restricting the operations of a secondary market." In these circumstances, the fact that the letter sought to achieve observance of this requirement, through an interpretation of Section 26 (f) (2), consistent with the purpose of that provision, should afford appellant no ground for complaint. This is particularly so since Section 26 (c) requires that the sales agreement contain the provisions of Section 26 (f), which appellant also recognizes as "not restricting the operations of a secondary market."

The foregoing acknowledgment by appellant, which correctly reflects the nature of Section 26, disposes of the June 22, 1959 letter. But then at a later point in appellant's argument the letter is transformed. By virtue of the letter. appellant asserts that Section 26 had the effect of inhibiting the development of secondary markets (Br. 51, note 47). In an effort to avoid the jurisdictional problem under the Maloney Act which this approach generates, appellant engages in razor edge semantics. It states that it is not challenging the NASD rules, but their "effect" (Br. 51, note 47). Appellant's hypothesis evidently is that an NASD rule —which enjoys antitrust immunity under Section 15A (n) of the Maloney Act—and its effects are severable, with the Commission's exclusive, embracing and continuing jurisdiction described earlier so sterile that it somehow encompasses consideration of the rule itself without regard to its impact, which is a distinct subject to be considered separately in some other forum under the antitrust laws. The matter need not be labored. The Commission is fully fortified with jurisdiction to consider the effects of an NASD rule or its interpretation, and to determine whether it implements or contravenes the statutory standards, including the Maloney Act "restrictions . . . upon anti-competitive rules"[30] and the purposes of the Investment Company Act. See notes 4 and 20, *supra*.

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[30] *National Association of Securities Dealers, Inc.*, Securities Exchange Act Release No. 9682 (June 7, 1972) p. 5.

Although for the reasons stated, including appellant's own acknowledgments, the June 22, 1959 letter is irrelevant, we shall nevertheless make some further observations about the letter in view of the attention given it by appellant as it endeavors to inject it into this proceeding.

Our Motion to Dismiss filed in this Court (pp. 14-19) contains a full description of the entire background of the letter. That narrative, which need not be repeated here, shows, contrary to appellant's intimations, that the letter was wholly consistent with the advice received from the Commission's staff and was communicated to the NASD membership in accordance with the wholly proper, general practice of the NASD to inform its members of advice it receives from the Commission or its staff.

Appellant originally thought, as it urged below in its brief in opposition to our motion to dismiss, that the letter had to be submitted to NASD members for a vote and had not been as part of some clandestine intrigue which even resulted in the letter's concealment from the Commission. Appellant no longer makes these assertions. It has now learned that no vote was required in view of *National Association of Securities Dealers, Inc.*, 17 S.E.C. 459, 465 (1944) and that NASD letters to its members are routinely sent to the Commission as part of its continuing oversight.[31] Nevertheless since this vintage letter has, as a result of lack of any remaining postulate of wrong, become the strand on which appellant seeks to hang its case against the NASD, appellant has now decided that an evidentiary hearing is necessary as to the circumstances surrounding this irrelevant letter (Br. 61-62).

The purpose of this judicial hearing under the antitrust laws would be to determine whether the letter "was in fact necessary to implement effectively the Investment Company Act, and was no more restrictive than necessary". The

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[31] See Rule 15Aj-1(d), 17 C.F.R. 240.15Aj-1(d) adopted by the Commission under the Maloney Act.

antitrust court would thus in effect review, in terms of the foregoing standards, the NASD rule and the action of the Commission.[32] In passing upon the rule the Commission has already concluded, as pointed out above, that it was authorized by Section 22 of the Investment Company Act and was consistent with the competitive criteria of the Maloney Act. Appellant's approach would nullify Section 15A (n) of the Maloney Act and the antitrust immunity it provides. See *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 357-360, see also note 23, *supra.*[33]

In its efforts to press this case into the antitrust mold appellant endeavors generally to minimize the role and involvement of the Commission in the activities of the NASD. For example, it portrays the Commission's function as if it were peripheral (Br. 54). However, the fact is that the Commission, by virtue of the Maloney Act and the Investment Company Act, exercises comprehensive oversight and review over the activities of the NASD. They are under

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[32] This contradicts appellant's statement that "it does not question any action taken by the Commission nor seek to overturn any NASD rule" (Br. 51).

[33] Appellant mentions (Br. 11), but never elaborates on the allegation in the complaint of suppression of market quotations. It is well advised, for it would suffer more of the frustration it has already experienced in attempting to mold an antitrust action on matters within the exclusive jurisdiction of the Commission. There is a network of statutory regulation to assure the integrity of quotations. Under Section 15A (b) (12), 15 U.S.C. 78o-3 (b) (12), the NASD is required, as it has, to adopt rules "designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations." See, e.g., NASD Rules of Fair Practice, Art. III, Sections 5 and 6. These rules are subject to the Commission clearance and oversight under the Maloney Act as discussed earlier. In addition, the Commission itself is specifically authorized to regulate the matter of quotations under Section 15 (c) (2) of the Securities Exchange Act, 15 U.S.C. 78o (c) (2). This is in addition to the general anti-fraud provisions of the Securities Exchange Act, which arm the Commission with direct regulatory authority, that would reach "suppressed" quotations.

the constant scrutiny of the Commission either through formal procedures or through the workings of the informal administrative process. Appellant also states (Br. 48) that in approving Section 26 of the NASD Rules of Fair Practice, the Commission's action was one of "non-disapproval". The Commission's role, however, is neither passive nor non-participatory. As already stated, the Commission is under a "duty" to reject or rescind an NASD rule as to mutual funds, if it, for example, is not authorized by Section 22. See note 20, *supra*. Yet appellant, without any warrant, states that the Commission's action "does not imply that the rule is necessary to the implementation of the regulatory scheme" (Br. 48, note 42).

We shall now turn to a consideration of the complaint's approach to the Investment Company Act, and where necessary as an incident to the analysis, reference will be made to contractual restrictions which are the subject of Counts II to VIII of the complaint, although such restrictions are not required by the NASD, either by rule or otherwise.

II. SECTION 22 OF THE INVESTMENT COMPANY ACT PROTECTS THE PRIMARY DISTRIBUTION SYSTEM. ITS DESIGN IS REGULATION RATHER THAN COMPETITION AND CARRIES WITH IT IMMUNITY FROM THE ANTITRUST LAWS.

The essence of appellant's complaint is that the effects of the present system of selling mutual funds shares, in the language of the court below, is to "cause the public to pay artificial and non-competitive sales loads for mutual fund shares," (J.A. 334). Appellant is endeavoring through the antitrust laws to achieve competitive sales charges in some mutual fund sales.[34]

Appellant acknowledges that the regulatory pattern of the Investment Company Act, and not the competition of the antitrust laws, governs sales and charges to investors in

[34] As appellant points out (Br. 9): "Only the 'load' or sales commission can be affected by sales in secondary markets."

both the primary distribution and in the secondary dealer market in issued and outstanding shares, the traditional sources of mutual fund shares for investor purchases. Appellant argues, however, that this admittedly broad and intended antitrust immunity does not reach one facet, a secondary brokerage market solely between investors, which has never yet existed and which the Commission for the first time is now proposing to introduce, and on a circumscribed basis.[35] Appellant would bifurcate the unity and regulatory pattern of the Investment Company Act and seeks to create, solely for this brokerage segment of sales of mutual fund shares, a dichotomy between the Investment Company Act and the antitrust laws. Appellant believes it has found a crevice in the statute's wall of antitrust immunity.

A. The Statutory Provisions

Section 22 of the Act deals specifically with each of the two components that make up the price of a mutual fund share, i.e., net asset value and sales load, and also with the price at which mutual fund shares are to be sold to investors both in the primary distribution and thereafter.

Section 22 (a) has remained unchanged since the Act was passed in 1940. In substance, it authorizes the NASD to adopt rules to protect existing shareholders from a dilution of their equity or other unfairness so that the "minimum price" at which shares may be purchased from a mutual fund (and also the "maximum price" which it may pay on redemption) is in "relation to the current net asset value" of the security.

Section 22 (b) by its terms deals with the sales charges in a primary distribution, but its impact carries over to the

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[35] As will be discussed below, the Commission in its November 1974 report is not proposing a conventional brokerage market because of the very policy strictures of the statute which appellant's approach denies.

secondary market in issued and outstanding shares, as discussed below. Prior to 1970, when the statute was amended, Section 22 (b) in substance authorized the NASD to adopt rules so that the offering price would "not include an unconscionably or grossly excessive sales load." The 1970 amendments, which are fully explored below, continued the NASD rule making authority, but the standard was changed so that the offering price "shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors."[36]

NASD rules become effective only after they have been passed upon by the Commission in terms of their being authorized by Section 22 and consistent with the applicable standards of the Maloney Act. In addition, the Commission may adopt rules altering, supplementing or superseding NASD rules.[37] Thus, in effect, the Commission has exclusive jurisdiction of the matter.[38]

The 1970 amendments also added Section 22 (b) (4) to the statute which, in terms identical with Section 15A (n) of the Maloney Act, provides for antitrust immunity. Both the Senate and House Reports said of this section:

> "This provision, which is identical to Section 15A (n) of the Securities Exchange Act, is designed to make it clear that no other provision of Federal law, including the antitrust laws, prevents a registered securities association from adopting rules consistent with, and neces-

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[36] The amended Section 22 (b) relieves such rules from compliance with Section 15 (A) (b) (8) of the Maloney Act to permit rules prescribing methods for computing, and limitations on, sales loads.

[37] Section 22 (b) (3) and 22 (c) of the Investment Company Act.

[38] Section 25 (a) of the Securities Exchange Act of 1934, 15 U.S.C. 78y (a), and Section 43 (a) of the Investment Company Act, 15 U.S.C. 80a-42 (a), both provide for review of Commission orders by the Circuit Courts of Appeals.

sary to effectuate, the purposes and provisions of this section." Senate and House Reports, note 54, *infra*, at pp. 18 and 30, respectively.

Section 22 (d) of the Act provides for retail price maintenance. As discussed below, proposals for its repeal were rejected in connection with the 1970 amendments, and it was reenacted with amendments not here pertinent. Its reenactment was integral to the action taken by the Congress. Section 22 (d) provides in pertinent part:

> "No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus."

Section 22 (d) is of general application. It draws no distinction between newly issued shares in a primary distribution and transactions in the secondary market in already outstanding shares. Nor are its proscriptions limited to those who have sales agreements with the underwriter. As long as a mutual fund is offering shares—and this is the common situation—Section 22 (d) applies. Retail price maintenance is required; it is not permissive as appellant at one point states (Br. 53). It should also be noted that while Section 22 (b), which as pointed out above deals with the sales load, is cast in terms of the primary distribution, it is the load permitted under Section 22 (b), together with the per share net asset value, which determine the public offering price that must be maintained under Section 22 (d), even in the secondary market. Section 22 (d) refers to a "dealer", with no reference to a "broker". As

will be discussed below, this is attributable to the fact the secondary market has always been a dealer market; a brokerage market has never existed.

The secondary dealer market provides no monetary advantage to the purchasing investor. As appellant acknowledges (Br. 9) the retail price maintenance provisions of Section 22 (d) apply to *all* dealer sales to investors, including those made by noncontract dealers in the secondary market.[39] It applies as well, as appellant recognizes (Br. 25, 35-36), even if there is an intermediate broker, whether the broker acts for the customer, for the dealer, or for both.

B. The Purpose and Origin of Section 22

The objectives of Section 22 (d) have been explained by the Commission time and again in the following terms, with which appellant disagrees:

> ". . . the purposes of Section 22 (d) as stated by the Commission 'are to prevent discrimination among purchasers and *to provide for orderly distribution* of such shares by preventing their sale at a public price less than that fixed in the prospectus.' [citing Investment Company Act Release No. 2798 (December 2, 1958)] . . . Section 22 (d) seeks *to prevent* the adverse effect upon investors generally which would result from discriminatory pricing and *disorderly distribution*."[40]

Prior to the passage of the Act, the so-called "bootleg market" provided secondary market price competition in mutual fund shares. This competition existed between

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[39] Accordingly, there is no basis for appellant's intimation that Section 22 only concerns itself with the "links in the primary distribution of shares from fund to underwriter to dealer to investor", or the analogy which it seeks to draw to state fair trade laws and the second-hand market (Br. 23-24).

[40] *Spiro Sideris,* Securities Exchange Act Release No. 8816 (February 13, 1970), p. 2.

contract dealers, who had distribution agreements with the principal underwriters and were obligated to sell fund shares at sales loads fixed by the principal underwriter, and dealers who did not have such an agreement and obtained shares from sources other than the principal underwriter, reselling them at whatever price they chose. This caused dealers to cancel their contracts with principal underwriters. As described in the Commission's Investment Trust Study that led to the passage of the statute initially, these non-contract

> "dealers would often offer a little more than the published redemption price and ask a little less than the published sales price . . . A certain amount of protection was received by such operators through their ability to obtain shares from the legitimate distributors if these dealers were short. Such operations actually had the effect of initiating a small scale price war between retailers and tended to disrupt the established offering price." (Footnotes omitted.) [41]

A response to this competitive situation and its consequent disruption of the primary distribution was Section 22 (d), which came about in the following circumstances: The original bill recommended by the Commission did not contain this provision. Extensive Senate hearings were held on that bill,[41a] and the industry, while not opposing legislation, did not agree with the Commission's proposals. A spokesman for the industry suggested the framework of an acceptable bill.[42] With respect to Section 22, he stated that it

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[41] *Investment Trusts and Investment Companies,* Report of Securities and Exchange Commission ("the Commission Investment Trust Study"), Part 3, p. 865; see also Part 2, p. 241, n. 100.

[41a] Hearings before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, 76th Cong., 3d Sess. on S.3580 (1940).

[42] *Ibid.,* p. 1053.

"... should also provide that no securities issued by an investment company shall be sold *to insiders or to anyone* other than an underwriter or dealer except on the same terms as are offered to other investors."[43]

This proposal, almost in verbatim language, was again set forth in a memorandum agreement between the Commission and the industry.[44] This agreement produced a compromise bill[45] that included Section 22 (d) and was enacted. The Senate Committee Report on that bill states:

"In addition, provision is made to prohibit the sale of redeemable securities *to any person* other than a dealer or principal underwriter at a price less than that at which the security is sold to the public." Sen Rep. No. 1775, 76th Cong., 3d Sess., p. 16.

This statement, as appellant points out (Br. 32), makes no reference as such to the secondary market. However, it does not refer specifically to the primary distribution either. It embraces both by the general statement that sales of redeemable securities "to any person other than a dealer or principal underwriter" must be made at the public offering price. No distinction is drawn between the primary distribution and the secondary market. Sales to public investors in either are to be made at the public offering price; and Section 22 (d) so provides.

Appellant, nevertheless, argues (Br. 19-20), as its fundamental premise, "that Section 22 (d) was addressed to abuses in the primary distribution of mutual fund shares, not to secondary level transactions." However, appellant

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[43] *Ibid.*, p. 1057.

[44] Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, H. Rep., 76 Cong., 3d Sess., on H. R. 10065, p. 99.

[45] *Ibid.*, p. 96.

acknowledges, as already stated, that Section 22 (d) —the purpose and intent of which reflects the above quoted statements—embraces transactions solely in the secondary market that are in and of themselves wholly unrelated to the primary distribution. This was not an inadvertence, as would seem to be the implication of appellant's approach. If Section 22 (d) were meant to deal only with abuses in the primary distribution, as appellant urges, it could and would have been so limited. The statute was drafted as it was because it was designed to frustrate the secondary market in its disruptive effect on the primary distribution system by denying the secondary market its competitive price advantage.[46]

In order to protect the primary distribution, the statute also accepted the denial to a selling shareholder of the opportunity of possibly receiving in the secondary market something more than the redemption price. This, as appellant recognizes (Br. 9-10), is the only possible price benefit that an investor could derive from a secondary dealer market.

The Commission's Investment Trust Study (Part 3, p. 865) pointed out that certain mutual funds attempted to overcome the price competition of the "bootleg market" by restricting the negotiability of their shares, and providing that they could only be sold or tendered for redemption to the mutual fund. These restrictions denied the selling shareholder the possible price benefit of the secondary market. Significantly, in disregard of this possible benefit, Section 22 (f) of the Act permits restrictions on transferability and alienability, subject to disclosures in the fund's

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[46] This is not to say that the statute does not also "protect open-end mutual fund investors against the dilution of their equity due to 'in-and-out' trading by insiders", the sole purpose ascribed to Section 22 (d) by appellant (Br. 32-33).

registration statement and Commission rule making authority, which it has thus far not exercised.[47]

In summary, the drafters of the statute, who arrived at the compromise that led to its enactment, were fully aware of the fact that there existed a competitive secondary market in mutual fund shares which might provide a price benefit to both the purchasing and the selling investor. They also knew that this secondary market produced adverse consequences on the primary distribution system from which the mutual fund industry wanted protection. And it succeeded. The conclusion was reached to deny price benefits in order to protect the primary distribution system.

C. The 1970 Amendments

Appellant simply ignores the wholly relevant subject of the 1970 amendments and their background as it must if it is to adhere to its approach. This material does not reveal any novelty of statutory purpose.[48] It confirms in detail the proposition, which appellant refuses to accept, that Section 22 of the Investment Company Act, with its retail price maintenance and its acceptance of contractual restrictions, is designed to protect the primary distribution system and its fixed sales charges from the competition of a secondary market. Although urged, the Congress deliberately refused to abandon this purpose; it reenacted Section

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[47] Congress was aware that there were contractual restrictions that "presents a whole problem which they call the bootleg market." Senate Hearings, note 41a, *supra*, p. 292. We shall not discuss the relationship of Section 22(f) to the contractual restrictions here involved, which we understand will receive detailed treatment in other briefs.

[48] Even if it did, it would be wholly relevant. In preoccupying itself exclusively with the 1940 legislative history and ignoring the 1970 amendments, appellant for all intents and purposes is engaging in an academic exercise of historical interest.

22 (d) and expressed unequivocally its intent to continue this design.[49] The whole matter of sales charges, to which appellant's complaint is directed, was approached as not even being within the ambit of the antitrust laws, a view then shared by appellant and communicated to the Congress. It was with the filing of the complaint here in Febuary 1973 that appellant for the first time asserted that the antitrust laws applied to sales charges.

The Congress fully considered the entire subject of the distribution and sale of mutual fund shares, including the secondary market and competition. Sales charges, the subject of this litigation, were a focal point of the Congressional deliberations. While the Congress wanted to protect the purchasing investor from excessive sales charges, it also wanted to assure the seller "reasonable compensation" not dictated by competition. It even refused to impose a statutory ceiling on sales charges. Congress was made fully aware of the situation to which appellant's complaint is addressed, that "sales of mutual fund shares have been confined to a primary distribution system" and that "the public has been deprived of the benefits of free and open competition" of secondary markets (J.A. 10). The Congress rejected competition and refused to revive the secondary market. The matter of sales charges was again committed to the Commission's jurisdiction, as it had been, but under new standards. It was viewed as a matter best treated in the administrative forum.

In 1966 the Commission submitted a report to the Congress in which it recommended statutory amendments in light of the developments that had taken place since the passage of the Investment Company Act in 1940. *Report*

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[49] These circumstances render inapposite appellant's quotation (Br. 40-41) from *Securities and Exchange Commission* v. *Capital Gains Research Bur. Inc.*, 375 U.S. 180, 199-200, and distinguishes *United States* v. *Philadelphia Natl. Bank*, 374 U.S. 321, which appellant also cites.

of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth (1966) ("the 1966 Commission Report").[50] The Commission's recommendations were embodied in bills introduced in the 90th Congress, and the matter was carefully considered by the Congress over a four year span. In 1967, hearings were held before the committees of both the Senate and the House of Representatives.[51] The Senate Committee reported out a bill,[52] which was passed by the Senate. The House Committee took no further action.

In the 91st Congress, bills were again introduced, and further committee hearings were held on both sides of the Congress.[53] This time bills were reported out by both committees,[54] and following a conference,[55] the amendments were enacted in 1970, Public Law 91-547. It may be noted that both the House and Senate bills (as was true

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[50] Printed as H. Rep. No. 2639, 89th Cong., 2d Sess.

[51] Hearings before the Committee on Banking and Currency, U.S. Senate, 90th Cong., 1st Sess., on S.1659; Hearings before the Subcommittee on Commerce and Finance of the Committee of Interstate and Foreign Commerce, House of Representatives, 90th Cong., 1st Sess., on H.R. 9510, H.R. 9511. Referred to as "1967 Senate Hearings" and "1967 House Hearings", respectively.

[52] S. Rep. No. 1351, 90th Cong., 2d Sess.

[53] Hearings before the Committee on Banking and Currency, U.S. Senate, 91st Cong., 1st Sess., on S.34 (which contained the text of the bill passed by the Senate in the 90th Cong.) and S.296 (1969); Hearings before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 91st Cong., 1st Sess., on H.R. 11995, S.2224 (which was the bill passed by the Senate in the 91st Cong.), H.R. 13754 and H.R. 14737. Referred to as "1969 Senate Hearings" and "1969 House Hearings", respectively.

[54] S. Rep. No. 91-184; H. Rep. No. 91-1382. Referred to as "the Senate Report" and "the House Report", respectively.

[55] H. Rep. No. 91-1631.

also of the Senate Bill passed in the prior Congress) adopted the regulatory format embodied in Section 22 (b).

The 1966 Commission Report to the Congress called attention (p. 42) to the fact that there was only a small trading market for mutual fund shares. The report reviewed at great length (pp. 201ff.) the entire subject of the distribution of mutual fund shares, and particularly the sales load. While the Commission was of the view that existing sales loads should be lowered (pp. 221, 222), it indicated (p. 218) an inability to act under the then existing statutory standard proscribing "unconscionable or grossly excessive" sales loads.

Then the report (pp. 218 ff.) dealt at great length with retail price maintenance. Section 22 (d) was described as "an exception to the usual congressional policy, expressed in the antitrust laws, against price fixing" (p. 218). Section 22 (d) was referred to as one of the "statutory controls with respect to sales loads" (p. 218). It was pointed out that Section 22 (d) "effectively prevents any price competition among dealers", and requires them to "adhere rigidly to the offering price whether the shares they sell are newly issued or already outstanding" (p. 218). It should be noted in this connection that the report used the term "dealer" in a generic sense to refer to a retail securities firm in the over-the-counter market without regard to the capacity in which it acts. Where the matter of capacity was relevant, it was delineated, e.g., p. 53. The references to "dealer" during the Congressional hearings and in the Congressional reports were also made in the same manner.

The background of Section 22 (d) was explained (p. 219) in terms of the "bootleg market" and its consequences basically as set forth herein earlier. It was then emphasized that Section 22 (d) is unique and is "an exception to the general rule that in the over-the-counter markets charges for executing transactions are subject to negotiation" (p. 219).

The report then addressed itself to possible methods of achieving the lower sales loads that the Commission sought. The report considered the elimination of Section 22 (d), pointing out that the advantage of such a step would be that it "would allow the proper level of sales loads to be determined by the freely active forces of retail price competition" (p. 222). The Commission rejected this approach because it could result in price discrimination. It "would permit knowledgeable investors to purchase mutual funds shares at sales loads substantially lower than those now prevailing, but others—among them those most in need of protection—might save little or nothing" (p. 222).[56]

The Commission then advocated a statutory ceiling and recommended in essence that "[s]ales charges for mutual fund shares may not exceed 5 percent of their net asset value at the time of sale" (p. 223). In this connection the Commission observed (p. 223):

> "Moreover, the mutual fund industry has operated for over a quarter of a century under the anticompetitive protection against price competition afforded by section 22 (d). A maximum sales load would avoid any unsettling and unforeseeable effects which abolition of retail price maintenance might have on the broker-dealer community . . ."

These "unsettling and unforeseeable effects", and the intimate interrelationship between the primary distribution and the secondary market in terms of the function and impact of Section 22 (d), were later elaborated upon during the Congressional hearings by the then chairman of the Commission:

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[56] The Commission also thought elimination of Section 22 (d) might at least temporarily favor captive organizations, which are not involved here, that are the sole distributors of the fund shares they sell (p. 222).

"They [the mutual fund industry] felt that the lifting of section 22 (d) would be disastrous for the funds and those who sell them. They said that the dealers who wanted to sell mutual funds would stop buying them from principal underwriters and purchase them at cut prices in the market, and that mutual fund sales charges would thereby be driven down to a point where most dealers would stop selling them at all. In other words, they said the force of competition would reduce the charge.

"They said that as a consequence the existing system of distribution would break down, the underwriters would be unable to make enough sales to offset redemptions, and the funds would be thrown into a net redemption status, and ultimately wither away." 1967 House Hearings, p. 713.

As will be seen, it was Congressional concern with these adverse consequences of a competitive secondary market on the primary distribution and on the funds themselves which, *inter alia,* led Congress to embrace regulation and reject competition.[57]

Although it would have been very much relevant, nowhere in its comprehensive report did the Commission even mention the administrative interpretation, on which appellant pivots its case and which will be discussed below, that Section 22 (d) does not prohibit a broker from effecting a transaction between customers at a price lower than the public offering price. Nor did the Commission, or anyone else, refer to it in the extensive Congressional hearings or voluminous memoranda that were submitted. In the single allusion by the Commission to the matter, its then chairman negated the interpretation:

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[57] Appellant nevertheless argues that "a secondary market cannot . . . undermine, or even adversely affect, primary distribution of fund shares at a 'current price offering price' ", and that "it was not a matter of concern to Congress." (Br. 20).

"The statute is unequivocal. No person, no matter where he gets it, from the issuer, from another dealer, or even from a private person, *no broker-dealer* may sell a share of a particular fund at a price less than that fixed by the issuer." 1967 House Hearings, p. 711.

There is not even an intimation in the 3500 page legislative record, to which we now turn, that there could be a deviation in any way from the sales charge fixed by the underwriter, or that the antitrust laws, which were referred to repeatedly, might in any way be relevant. On the contrary, the constant refrain, repeated time and again, was the immutability of the fixed sales charge and that the whole system of pricing and sales charges was free of the antitrust laws. These were the postulates. The absence of competition was the recurring theme. This is not a case where the legislative record is silent or ambiguous on the application of the antitrust laws so the matter must be resolved by implication. The record here is explicit. The Congress intended that Commission regulation should supplant competition, the object of the antitrust laws, in the whole area of pricing and sales charges.

At the outset of the 1967 Senate Hearings the committee chairman observed (p. 1) that the Commission's report "correctly emphasized the serious problems" that had arisen since 1940, "especially in the area of mutual fund sales commissions . . ." The chairman of the Commission referred to sales charges as a "major" problem that has "received the greatest attention" (pp. 5, 25, see also p. 126). His presentation essentially repeated the observations and recommendations in the 1966 Commission Report previously summarized. He referred to the Act's "special exemption from the antitrust laws" (p. 87) and to "the unique structure of this industry and existing restraints on competition, some imbedded in the act itself—and I have particular reference to section 22 (d)" (p. 4). He also observed, for example,

"mutual fund sales charges are not determined by the normal interplay of freemarket forces." (p. 25)

* * *

"It [Section 22 (d)] permits the fund's principal underwriters to fix sales charges and then requires the Federal Government to enforce adherence to those prices by every retail dealer whether or not he has a contract with the underwriter and whether or not he is engaged in the initial distribution of the fund's shares." (p. 25)

* * *

"If a retail dealer sells shares of a mutual fund for less than the price which is . . . stated in the prospectus because the dealer believes lower charges will enable him to increase his sales and his profits, he is guilty of a wilful violation of the Investment Company Act." (p. 25)

* * *

"Sellers of mutual fund securities have been insulated by Federal law from price competition at the retail level since 1940." (p. 26)

See also 1967 Senate Hearings, pp. 32, 50-51, 82, and 86.

This testimony was elaborated upon in a written statement (pp. 142-155), with reference again to the "exemption from the antitrust laws" (p. 142) and also to the pre-1940 "bootleg market" and Section 22 (d) (pp. 151, 153). In this connection it was pointed out that "we are dealing with an industry that had never known retail price competition"; that even before 1940 "there was a considerable degree of insulation from price competition by private contract"; and that the "competition that existed in the pre-1940 period seems to have had a truly disruptive effect . . ." (p. 153). The reasons were again recited for the Commission's not advocating competition, but a prescribed maximum sales load (p. 154), which was also the subject of another memorandum (pp. 173-174).

The chairman of the Senate Committee in describing the Commission proposal stated (p. 185):

> "In the area of sales loads, the Commission has suggested that in view of the statutory and other restraints on the normal forces of free price competition, a statutory ceiling on sales charges is required."

The Commission made a similar presentation at the 1967 House Hearings, e.g., pp. 30, 48-61, 109-114, 140-143, 193-197, 692, 701-703, 707, 713-715. In written memoranda it pointed out, for example:

> ". . . sales charges . . . are fixed under an exemption from the antitrust laws which prohibits price competition by dealers . . ." (p. 48).
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> "They [sales charges] are . . . fixed and maintained . . . under an exemption from the antitrust laws . . . . No dealer *anywhere* (not even a dealer who has no contract or contact with the principal underwriter and who obtains shares from other sources, *including investors*) can deviate from the price that the principal underwriter has set." (p. 701; a similar statement was made in the 1967 Senate Hearings, p. 142).
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> "Mutual fund sales charges are not free market prices determined by competition. They are fixed under an exemption from the antitrust laws . . ." (p. 109).
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> ". . . to introduce a competitive regime in this industry would be to break too sharply with its established ways of doing business" (p. 113).

The then Commission chairman in his testimony twice referred to Section 22 (d) as an "exemption from the antitrust laws" (pp. 140, 707) and observed (p. 673):

"It is a system under which the Federal Government authorizes the industry to operate outside the controls of the antitrust laws, . . ."

The Commission proposal met with a storm of opposition. The committee record in both houses is replete with testimony of witness after witness and written submissions, which condemned the proposal. In the process there was a thoroughgoing review of the distribution and sale of mutual fund shares, the level of sales charges, the need to assure sellers of mutual funds adequate compensation if they were not to be forced out of business, and the drastic consequences that would follow if the Commission's proposed statutory ceiling were enacted.[58] The Commission proposal did not prevail and, as will be shown, the Congress gave heed to these considerations in setting standards for sales charges.

Next, there were those, including appellant, that advocated the repeal of Section 22 (d), and the proposal was even embodied in a bill. This would have permitted the competitive sales charges of a secondary market. Repeal would not have terminated the contract primary distribution system, but would have revived the secondary market as its price competitor, and the resulting investor benefits were urged upon the Congress. Repeal would have restored the "disorderly distribution" which the statute terminated in 1940, and it was rejected by the Congress.[59]

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[58] See 1967 Senate Hearings e.g., pp. 187-188, 215, 225, 248, 267, 278, 302, 329, 551, 605, 646, 655, 658, 736, 751, 770, 779, 782, 788, 791, 809, 818, 873, 960, 964, 985, 986, 997, 998, 1077, 1097, 1100, 1112, 1117, 1129, 1166; 1967 House Hearings, e.g., pp. 233-237, 252, 265, 266-268, 282, 285, 293-297, 317-322, 325-334, 349-350, 381-383, 400-401, 405, 408, 467, 474-476, 484, 492-493, 496-497, 526, 528, 561, 563, 622, 625, 779, 782-783, 789, 820, 834, 835, 839, 840.

[59] As will be shown, the prevention of "disorderly distribution" was of primary concern also to the Commission in its November 1974 report.

In 1967 appellant recognized that "the fixed price policy embodied in Section 22 (d)" provides "the mutual fund industry an exception to the basic competitive requirements of the antitrust laws." It urged, however, that the small investor "should not perhaps be deprived of the opportunity of purchasing his investment at a price arrived at through the free operation of competitive forces." 1967 House Hearings, p. 21.[60]

Appellant's position during the 1969 House Hearings (pp. 135-136) is of particular moment and stands in sharp contrast with its current utilization of the antitrust laws to treat with the matter of sales charges. At that time, the Senate had passed its bill, but the House Committee had not yet reported a bill. Appellant called attention to the fact that the Senate Committee report "takes account . . . of the fact that Section 22 (d) . . . prescribes a unique scheme of retail price maintenance for . . . sales charges . . .", and points out that such charges for much higher than those otherwise prevailing in the securities industry. However, appellant continued, because the committee lacked adequate information as to the consequences of the repeal of Section 22 (d), it had requested a report on the subject from the Commission, and had proposed an amendment (which was enacted) to permit associations of securities dealers to deal with the problem of excessive sales loads. Appellant then stated:

> "*These steps are not inappropriate as interim measures.* However, the Department believes that con-

[60] Appellant at the same time stated:

> "It is our understanding that some consideration has heretofore been given to the possibilities of eliminating the price maintenance features of section 22 (d) from the statute. Because of the nature of the security business, however, *it has apparently been the view that to leave the matter to the free play of competitive forces would make for disorder in the industry.*" 1967 House Hearings, p. 21.

tinued attention should be given to the abolition or amendment of Section 22 (d). The arguments for retaining Section 22 (d) have not appeared persuasive to us, and we continue to think it likely that close examination of them will reveal that price competition in sales commissions can be allowed with advantage to investors."

A fair reading of the foregoing would indicate that appellant was accepting the Congressional formula and procedure for dealing with the sales load problem. Indeed, appellant even participated in the hearings that the Commission conducted to implement the Senate Committee's request for a report. Certainly, there was no intimation that appellant, which had earlier advised the House Committee that the mutual fund industry enjoyed an exemption from the antitrust laws, thought that the antitrust laws could be invoked to achieve the "price competition in sales commissions" which it favored and which the Congress refused to accept without further study of the matter, leaving the sales load problem for administrative regulation by the Commission. As will be shown, the House Committee paid special attention to appellant's espousal of competition.

The advocates of repeal also included Professor Paul A. Samuelson. He urged repeal of Section 22 (d) so that "there would spring up a secondary market for . . . mutual funds." 1967 Senate Hearings, pp. 348, 356, 366; see also, 1969 Senate Hearings pp. 55, 58, 64. In the latter hearings he stated (p. 62):

"Government now makes it impossible for there to be a free secondary market in mutual funds."

Professor Richard W. Jennings, who shared Professor Samuelson's views, observed that "there is no competition at the retail sales level" and that "there is a noncompetitive situation by Government action", pointing out:

". . . if I want to sell my mutual fund shares, I have to sell those back to the company, or if I want to buy,

> I can't buy them on the open market. If you repeal 22 (d) there would develop a market by buyers and sellers which would cut that cost." 1967 House Hearings, pp. 639, 647, 649.

In this connection a financial editor observed: "There are no discount houses in mutual funds." 1967 House Hearings, p. 655.

The views expressed to both the Senate and House Committees in 1967 by Professor Henry C. Wallich are of particular moment for they bring into focus the potential benefits of a competitive secondary market to both buyers and sellers. Referring to the consequences of the repeal of Section 22 (d), which he then favored, he observed:

> "It is claimed that a 'bootleg', i.e., free market would then arise in which investors wishing to redeem could sell their shares at slightly more than the current market value which the fund itself offers. The shares would then be resold for less than what the fund would charge (including sales load). Such a market which would be perfectly legitimate, would obviously be beneficial both to investors who redeem and who purchase. The fund would lose the sales load on the shares turning over in the market instead of being reissued by it . . . the availability of shares in the market would drive down the sales load . . ." 1967 House Hearings, p. 586; to the same effect, 1967 Senate Hearings, p. 1064.

During the 1969 Senate Hearings (pp. 144-147, 152) Professor Wallich, however, stated that he would hesitate to recommend the repeal of Section 22 (d) without examining the damage it might do to the mutual fund industry.[61]

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[61] Professor Sidney Robbins also recommended extensive studies before eliminating or modifying Section 22 (d). 1967 Senate Hearings, p. 255.

The chairman of the Council of Economic Advisers suggested: "The possibility of eliminating present restrictions against full competitive freedom in setting sales commissions deserves thorough consideration as an alternative or a supplement to the proposed ceiling on load charges," 1967 Senate Hearings, p. 957.

Repeal of Section 22 (d) was also proposed by others. See 1967 Senate Hearings, pp. 667-670, 731, 1018; 1969 Senate Hearings, pp. 173, 183; 1969 House Hearings, p. 775.

A proposal to repeal Section 22 (d) was embodied in a bill introduced in 1969 by Senator McIntyre, one of the members of the Senate Committee. S.296, 91st Cong., 1st Sess., §12 (a). Senator McIntyre stated that Section 22 (d) "makes it a Federal crime for salesmen to offer shares with commissions different from those established by the fund's underwriter" and that his bill "would permit commission levels to be established by the free interplay of competitive forces in the open market." 1969 Senate Hearings, p. 5.[62]

In response to questioning by Sen. McIntyre, a Commission spokesman stated:

> ". . . we don't know what conditions will result in the marketplace if 22 (d) is repealed.
>
> "We are told that wildcatting and price cutting will be ruinous to the industry. It might well be. We don't know the answers to those questions and to those possible results. It is because of that area of darkness that

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[62] A committee staff report summarized this provision in Senator McIntyre's bill as follows: "Repeals sec. 22 (d) of the Investment Company Act. Sec. 22 (d) allows mutual fund distributors and underwriters to fix sales commissions at a set price and makes it a Federal crime for *any broker-dealer* to sell these shares at a lower price. Repeal of Section 22 (d) would allow the competitive forces of the market place to determine mutual sales commissions." 1969 Senate Hearings, p. 4.

> we just didn't feel we had enough economic background and strength to come up here and recommend a repeal of this section." 1969 Senate Hearings, pp. 18-19.[63]

The Commission took the same position on the repeal of Section 22 (d) during the 1969 House hearings. The then chairman of the Commission twice again referred to Section 22 (d), "as an exemption from the antitrust laws" (p. 259, 862), "which prohibits retail dealers from engaging in retail price competition for customer favor" (p. 864). His attention was directed by the chairman of the House subcommittee to "a rather carefully considered opinion of the Department of Justice, that this section [22 (d)] be repealed" (p. 901), and the Commission chairman observed:

> ". . . it was represented to us that it would have very serious effects upon the industry. We had no means of measuring whether or not that was true, and just in an abundance of caution we refrained from making that recommendation."[64]

Instead of sales charges being determined by competition, or imposing a statutory ceiling on those charges, the Congress concluded that the matter should be left for reso-

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[63] For the industry's description of the adverse consequences that would result from the repeal of Section 22 (d) see e.g., 1967 Senate Hearings, pp. 320-322, 600-604, 608; 1969 Senate Hearings, pp. 91, 101-104, 119, 206, 425; and 1967 House Hearings, pp. 285, 827, and 830-832.

[64] Earlier in his testimony he had pointed out that the Commission's consideration

> "began with the suggestion that section 22 (d), the legal barrier to retail price competition, be repealed and normal market forces set price levels of mutual funds. It was suggested that, if this happened, fund distribution systems would be destroyed, dealers would no longer sell fund shares, funds would fall into a net redemption status and dump their portfolio securities . . ." 1969 House Hearings, pp. 864; see also p. 183.

lution under the jurisdiction of the Commission. As the Senate Committee pointed out, it was

> ". . . decided to rely on the existing self-regulatory machinery of the securities industry in order to protect public investors against unreasonable sales charges subject to appropriate Securities and Exchange Commission oversight." Senate Report, p. 8.

This was reiterated in the House Report (pp. 4-5).

As has been indicated, the statutory standard in Section 22 (b) relating to sales loads, which are applicable in both the primary distribution and secondary market, was refashioned. The standard to guide the NASD and the Commission in formulating rules as to sales loads reflected, *inter alia,* the extensive testimony that had been presented with respect to need for adequate sales charges. Section 22 (b) seeks to "assure that fair consideration is given to the interests of both sellers and investors." Senate Report, p. 18; to the same effect, House Report, p. 4. This statutory concern with "reasonable compensation for sales personnel, brokers-dealers, and underwriters" is the antithesis of sales charges determined by competition under the antitrust laws.

Because the rule making authority of the NASD was expanded, an exemption from the antitrust laws was specifically added in Section 22 (b) (4), even though appellant thought it was not necessary.[65]

The Senate Report (pp. 7-8), and also the House Report (p. 3) in practically verbatim language, stated:

> "The basic sales commission charged for mutual fund shares . . . is protected by Section 22 (d) of the Investment Company Act which provides for a unique scheme of retail price maintenance. Under this sec-

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[65] 1967 House Hearings 345.

tion, *all dealers, regardless of the source of the shares they sell, are prohibited by law from cutting the sales charge fixed by the mutual fund underwriter. Price cutting in this field is a Federal crime.*"

The Senate Report in this connection pointed out (p. 8) that shares of "particular mutual funds are not sold on a 'bid and asked basis' as are other securities offered and sold in the competitive over-the-counter market."

The two committee reports further pointed out that under the amendment ". . . *sales loads* fixed by principal underwriters . . . *continue to be protected against price competition* by section 22 (d) of the Act . . ." Senate Report, p. 18; House Report, p. 30.

Yet appellant urges that Section 22 (d) ". . . favors transactions in the secondary market at competitively fixed prices different from the . . . offering price . . ." (Br. 40).

In this connection the Senate Report (p. 8) pointed out that mutual fund sales charges are much higher than those that prevail elsewhere in the securities industry. It pointed out that the basic New York Stock Exchange commission is about 1 percent. It further pointed out that in over-the-counter securities transactions executed on an agency basis, a comparable commission is charged, and that when "the dealer acts as principal", the commission is usually between 2 and 3 percent and is limited by NASD rules to not more than 5 percent in almost all transactions. As has already been indicated, Congress refused to impose a 5 percent ceiling. Indeed, because of a concern that had been expressed, the Commission made it clear that it would not simply invoke its rule making power under Section 22 (b) as a means of achieving the same 5 percent ceiling.[66]

In the face of this legislative record, appellant's complaint is that there is an absence of competition from sec-

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[66] 1969 House Hearings, pp. 182-183, 214-215, 917-918.

ondary markets (J.A. 10) and that the Congress intended that the antitrust laws apply to the sales charges for a brokerage segment of mutual fund sales in the secondary market. The consequence of appellant's argument is that the Congress which sought to assure "reasonable compensation . . . for broker-dealers" not dictated by the competition of the marketplace, and which even refused to impose a 5 percent ceiling on sales charges, in either the primary distribution or in the secondary market, nevertheless intended that the competition of the antitrust laws should come into play on sales loads in one brokerage segment of the secondary market and even compel, as it could, a 5 percent, or still lower, sales charge. There is no basis whatever in the extensive legislative record referred to earlier for ascribing this intent to Congress. It is not necessary to reach the question whether the Commission, which is charged with the statute's administration, may effect this same result as a regulatory matter. The question here is whether the Congress intended that this result be obtained through the application of the antitrust laws.

As already indicated, the Senate Committee in its report stated (p. 8) that it had considered repealing Section 22 (d),[67] but that there was impressive testimony that there had not been sufficient study of the consequence of repeal. The committee requested the Commission to prepare a report on such consequences to "both the investing public and the mutual fund sales organizations" (p. 8). The Commission staff prepared such a report which did not make any express recommendations.[68] Before making any definitive recommendations the Commission decided to

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[67] In fact, it had done so in preliminary executive action. 1969 Senate Hearings, p. 19.

[68] *Report of the Staff of the Securities and Exchange Commission on the Potential Economic Impact of a Repeal of Section 22(d) of the Investment Company Act of 1940* (November 1972).

hold public hearings on the subject,[69] at which appellant appeared to urge competition and legislative repeal.[70] On November 4, 1974, the Commission released a staff report embodying recommendations,[71] which the Commission is now implementing, as will be discussed below. Meanwhile, to implement the provisions of the amended Section 22 (b), the NASD conducted extensive economic studies, which the Congress recognized would be necessary in view of the complexity of fund share pricing, and thereafter proposed rules which the Commission has cleared subject to certain modifications.

D. Administrative Precedent and the Secondary Market

We now turn to an analysis of the seeming statutory interstice from which appellant has shaped an approach that contradicts the Congressional intent and plan just described.

Section 22 (d) uses the term "dealer" and makes no reference to a "broker".[72] The axis of appellant's formulation is a Commission interpretation of Section 22 (d), first announced in 1941 as an opinion of its general counsel.[73]

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[69] In the Matter of Mutual Fund Distribution and the Potential Impact of the Repeal of Section 22 (d) of the Investment Company Act of 1940, File No. 4-164.

[70] *Ibid.*, pp. 2019 ff.

[71] *Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940* submitted by Division of Investment Management Regulation (August 1974).

[72] Mutual fund shares are not traded on stock exchanges, where all public trading is done in brokerage transactions. The Commission Investment Trust Study pointed out that a few issues of mutual funds had been listed on stock exchanges for the purpose of facilitating compliance with the "Blue Sky" laws of particular states, but that there never was any active trading on the exchanges. The absence of stock exchange trading was explained by the redemption features of mutual fund shares. Pt. 2, pp. 241-242, 281.

[73] Investment Company Act Release No. 87 (March 14, 1941).

Under this interpretation if a dealer is in any way involved in a sale to an investor, even though there may be an intermediate broker, and whether the broker is acting for the dealer or for the customer or for both, the prohibition of Section 22 (d) applies; it does not apply to a transaction in which one investor sells to another investor through a dealer "acting solely in the capacity of agent", i.e., broker.[74] This interpretation as to the pure brokerage transaction is the springboard for appellant's approach, although appellant reads more into it than was intended, as will later be shown.

As appellant views the matter, and this is the premise of its statutory analysis, the "broker" was omitted from the Section 22 (d) prohibition because he is "not a principal party" but is an "intermediary between buyer and seller" (Br. 23). Appellant proceeds from the incorrect premise that a securities firm in acting as "principal" or as "broker" necessarily has different roles, and that only when a firm acts as broker does it serve as "an intermediary between buyer and seller". A securities firm may or may not carry an inventory of shares, and if it does not, which is generally the case of a firm acting only as a retailer, it performs the identical intermediary function in a transaction between a buying investor and selling investor whether it acts as principal or as broker, a matter which it decides in the existing circumstances, unless it is otherwise contractually committed. Thus, for example, if a firm should happen to have simultaneously orders from one customer interested in sell-

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[74] This interpretation did not use the statutory definition of the term "dealer", which is defined in Section 2 (a) (11) of the Act to mean "any person regularly engaged in the business of buying or selling securities for his own account, through a broker or otherwise . . .". The general counsel took the position, without explanation, that "the term 'dealer', as used in Section 22 (d), refers to the capacity in which a broker-dealer is acting in a particular transaction."

ing and from another desirous of buying, and the orders can be matched in quantity of shares and in terms of execution, including price—the situation to which appellant addresses itself—the firm may, at its option, act as principal and simultaneously buy from one customer and sell to the other customer, or it can act as agent or broker for both customers. Thus, appellant's explanation of the statute in terms of difference in the "intermediary" function and market role of the "principal" and the "broker" is misconceived.

Proceeding from its misconception, appellant urges that whether the Investment Company Act or the antitrust laws governs the transaction between investors depends upon the form that the transaction takes. It is in effect argued that Congress drew a line predicated on the happenstance of form. Which statute applies, under appellant's approach, would depend upon the choice made by the intermediary securities firm as to the capacity in which it elects to act in effecting the transaction between customers, i.e., as principal or as agent. Under appellant's view, if the firm chooses to act as principal, the antitrust laws do not apply; the Investment Company Act and its overall regulatory pattern prevail. On the other hand, if the firm elects to act as agent, the antitrust laws are triggered and the Investment Company Act evaporates. Voluntary choice of capacity is thus the predicate of appellant's approach. This artificial and tenuous hypothesis with its preoccupation with form becomes the touchstone and is dispositive in determining which statutory regimen is applicable. Appellant proceeds from the premise, for which there is no basis as we have already shown, that a dichotomy between the Investment Company Act and the antitrust laws was intended as to a brokerage transaction between investors.

We are mindful, of course, of the fact that the fortuitous circumstance of capacity has been of moment to the Com-

mission in its interpretation of Section 22 (d).[75] However, it does not follow—and this is appellant's fallacy—that the Commission's interpretation, because it is relevant to the Investment Company Act, is therefore also relevant in determining the wholly unrelated question of the applicability and preemption of the antitrust laws. The Commission is charged with the administration of the Investment Company Act, including its retail price maintenance provision. Accordingly, it may adopt an interpretation in the context of that statute which it deems consistent with the statute's purpose and regulatory plan. But such interpretation by itself, even though it may be hospitable to some competition, does not for that reason catapult the matter into the antitrust arena and withdraw it from the embrace of the pervasive regulatory pattern of the Investment Company Act, which committed the matter of sales charges to the Commission's jurisdiction.

In any event, the language of Section 22 (d) and also the 1941 general counsel opinion must be considered in the context of the secondary market in mutual fund shares as it existed at the time the Act was passed. The Commission's Investment Trust Study that led to the statute initially characterized the "bootleg market" as an " 'inside' trading market."[76] The Study made certain observations about the secondary market in mutual fund shares on the basis of an analysis of four weeks of trading, which was considered fairly typical.[77] The study pointed out that "the sum total of trading includes primarily transactions: (1) between customers and retail dealers, (2) among retail

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[75] It might well be argued that the Commission's interpretation, in terms of the policy of Section 22 (d), is also vulnerable to criticism for parallel reasons, although it apparently does not view it as such.

[76] Pt. 2, p. 241, n. 100.

[77] Investment Trust Study, Pt. 2, p. 324.

dealers themselves, (3) between the retail dealers and the principal distributor or 'trading firms', (4) among the 'trading firms', and (5) between the 'trading firms' and the principal distributors."[78] These "trading firms", which were relatively small in number, traded with retail dealers, principal underwriters, and among themselves, but not generally with the public so that their trading was "really 'wholesale' in character."[79]

The Study further pointed out that the "reporting firms acted as principals rather than as brokers in practically all transactions."[80] Although the Study does not explain the matter, in view of the nature of the over-the-counter markets, as discussed below, it would appear that these brokerage transactions would have involved a retailer buying for a customer from a dealer, a transaction which would since 1940 be reached by Section 22 (d).

An indispensible ingredient of the over-the-counter markets are the so-called "market makers", who in effect serve as conduits and make the over-the-counter markets viable. They buy and sell as principal for their own account and maintain inventories in the particular securities in which they make a market. When a customer expresses an interest in buying or selling a security to the securities firm with which he deals, that firm, whether it is acting as a dealer or broker, will ordinarily look to the market maker to obtain or dispose of the customer's securities, as the case may be. The market maker is what the Investment Trust Study called the "trading firm", which dealt with the retailer who serviced the public customer. Since the market maker is a dealer, any purchase from him by a public customer, even if made through a broker, is covered by Section 22 (d).

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[78] Pt. 2, p. 325

[79] Pt. 2, p. 325.

[80] Pt. 2, p. 327.

In other words, for all practical purposes, the secondary market in mutual fund shares at the time the statute was enacted was made up of dealer, and not brokerage, transactions. In this context appellant's emphasis (Br. 22-23) on the absence of a reference in Section 22 (d) to a "broker" is misplaced. The public acquired its shares either directly or indirectly from a dealer. Thus, in the existing mode of transactions, the dealer reference in Section 22 (d) provided the full sweep needed to achieve the price fixing objective of the statute which the industry sought and obtained.[81]

The secondary market for mutual fund shares since the passage of the Act has also been an inter-dealer market. As is pointed out in a 1972 Commission staff study referred to by appellant, "the inter-dealer firms do not deal directly with the public."[82] The secondary market since 1940 has diminished. This was, of course, the intended purpose of Section 22 (d). But, as the foregoing Commission staff study pointed out, the diminution has also resulted from

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[81] In view of the emphasis placed by appellant on the terms "broker" and "dealer" (Br. 22) it is interesting to note that, like the 1966 Commission report, the Commission Investment Trust Study (Part 3, pp. 857-859) used the term "dealer" in a generic sense to describe a securities firm engaging in over-the-counter business, and the capacity in which the dealer was acting was delineated by references to "the dealer acting as principal" and to "the dealer acting as agent." This is reflected as well in the 1969 Senate Report (p. 8), which speaks of the "dealer [that] acts as principal." The dealer in a primary distribution, as previously pointed out, can take down shares only for orders he has already received, and he is designated as a "dealer" solely for the purpose of insulating the issuer and underwriter from liabilities for his acts. The comparability of market function of the "broker" and "dealer" in the secondary market, where the firm has no inventory, has already been pointed out.

[82] See note 68, *supra.*, Part II, p. 293.

other independent factors which has brought that market to its present reduced state.[83]

The 1941 general counsel opinion was rendered in response to a request from the NASD, which it appears was prompted by inquiries from the non-contract dealers who fully appreciated the fact that Section 22 (d) was directed at them and were concerned with its sweep. The 1941 opinion gave them no solace. It advised in effect that all dealers, in whatever capacity they acted, were embraced by Section 22 (d) as long as the source of their shares was another dealer, which as already indicated, was the common situation. The exception for the purely brokerage transaction between two public customers, which appellant highlights, was therefore of little, if any, consequence. The transaction was at most a rarity. According to the recent Commission staff report, it is only the recent advent of computer technology, and certain large securities firms operating with branch offices, that may make possible the matching of buy and sell orders on a broad scale.[84] But, as will be pointed out, the permissibility of such transactions, in the Commission's view, requires circumscription "to help neutralize any adverse impact on the funds primary distribution systems", which is the statutory mandate that appellant rejects.

Neither the general counsel opinion, nor *Oxford Company* 21 S.E.C. 681 (1946), in which the Commission itself accepted its general counsel's view, made any reference to

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[83] These included, for example, the disappearance of the redemption fee that mutual funds at one time charged and a lessening of the percentage of the sales load retained by the principal underwriter, which have both had the effect of reducing the spread between the redemption value of shares, and the price charged to retail dealers, thereby in turn reducing the non-contract dealer's incentive to seek out selling shareholders rather than purchase shares from the underwriter on a primary distribution. See note 68, *supra.*, Part II, pp. 290-294.

[84] See note 71, *supra,* at p. 108.

contractual obligations or their impact on the brokerage exception.[85] This matter was referred to, however, in a 1973 letter of a Commission staff officer quoted extensively by appellant (Br. 38, note 33). The letter (J.A. 247) which was written to an underwriter, refers to these earlier interpretations and states: "Accordingly, the Act does not prohibit a broker-dealer from acting as agent with respect to a client." But then the letter follows with a sentence which appellant omits that points up the relevance and indicates the overriding nature of any contrary contractual restrictions. The letter states: "It is not clear to me whether or not paragraph 3 of your Dealer Agreement prohibits such broker activity, but I assume that, if it does, you would waive the prohibition." (J.A. 247) Presumably if there were no waiver, the contractual prohibition would prevail. Certainly the contract was of moment. Otherwise there would have been no reason to refer to it.

If in fact it were the statutory policy that retail price maintenance was to be observed only in principal transactions and could not be required of contract dealers in a brokerage transaction, which is what appellant is urging, then contractual restrictions on brokerage transactions would contravene the statute itself and be invalid.[86] This is not the Commission's view, however. In connection with its current proposal to introduce a brokerage market, the Commission accepted the validity of such restrictions and has asked the NASD to adopt a rule that would ban them as discussed below.

It thus appears from the foregoing that the general counsel opinion and the subsequent references to it, were

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[85] The *Oxford* case stemmed from a unique holding that in the special circumstances presented the securities firm could only act as a broker and could not elect to sell shares to the customer as principal.

[86] Section 47 of the Act, 15 U.S.C., 80a-§46, provides for the "voiding" of contracts made in violation of the statute.

directed solely to the restrictions that arise by virtue of Section 22 (d) and not to those that emanate from contract.[87] More specifically, as here pertinent, Section 22 (d) defines and limits the price restraints on the non-contract dealer, whose price cutting led to the enactment of Section 22 (d), but the contract dealer may be restrained additionally by his contract.

The Commission's own recognition of its brokerage interpretation during the intervening years, and its viability, should also be considered in terms of an amendment to Section 24 (d) of the Investment Company Act. The amendment was enacted in 1954 in connection with a general overhaul, under Commission sponsorship, of the prospectus requirements of the securities laws. The prospectus is a fundamental and threshold investor protection; it is the statutory vehicle for informing the investor about his investment.

The amendment, as the Commission stated at the time of its enactment, in the case of mutual funds "requires the use of prospectuses in *all* transactions [i.e., both on the primary distribution and in the secondary market] so long as securities of the same class are currently being offered or sold by the issuer by or through an underwriter."[88] Yet, the recent Commission staff report, which recommended the introduction of a brokerage market, observed (note 71, *supra,* at p. 107, note 1): "It would not appear possible for the Commission to require brokers to deliver prospectuses in the case of all secondary market transactions, although

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[87] As the recent Commission staff report stated in this regard: ". . . there is no *statutory requirement* that the offering price in the prospectus be maintained in a brokered transaction". Note 71, *supra,* at p. 104.

[88] 20th Annual Report of the Commission, p. 2. See S. Rep. No. 1037, p. 20, H. Rep. No. 1542, p. 30, accompanying S.2846, all in 83rd Cong., 2d Sess. which embodied the 1954 amendments.

the broker would be required to do so . . . if he happened also to be a dealer of the fund being purchased." Thus, the 1954 amendment, although it was intended to provide all investors with a prospectus, is deficient to this purpose; it was apparently drafted on the premise that mutual fund shares were and would be traded in the secondary market on a dealer basis, and not a brokerage basis. Of course, there would be no reason to deny an investor the all important prospectus because he happens to deal with a security firm that has decided to act as broker rather than as principal. The result is a patent statutory incongruity.[89]

The operation of the administrative scheme is also peculiar as it relates to brokerage transactions. The Commission's Rule 22c-1 under the Investment Company Act, 17C.F.R. 270.2c-l, requires "forward pricing", i.e., net asset value must be computed after the receipt of a purchase order or a tender for redemption. The rule encompasses a dealer, with no reference to a broker. And mindful of this, the recent Commission staff report (p. 107, note 1) would in effect require the broker in the brokerage market now being proposed by the Commission to inform investors that they might not fare as well as they would if Rule 22c-1 did apply.

The foregoing makes it clear that the question of the brokerage transaction under the statute cannot be determined by a simplistic approach. The matter is complex. It has received varied treatment and, as previously pointed out, the brokerage exemption was even specifically negated by the Commission during the Congressional hearings that led to the 1970 amendments. The matter of the brokerage transaction can only be resolved in terms of overall statutory policy and purpose, and not by invoking an adminis-

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[89] In fact, a serious question could be raised as to the advisability of permitting a brokerage transaction without assurance that the investor will receive the threshold protection of a prospectus. Blind investment is not a bargain even if the sales charges are minimal.

trative interpretative rubric and even assigning it a breadth which was not intended.

While appellant treats the brokerage interpretation first enunciated in the general counsel opinion as the end of the matter—withdrawing the brokerage transaction from the embrace of the Investment Company Act and subjecting it to the antitrust laws—the Commission views the interpretation only as the beginning of the inquiry with respect to its statutory consequences and the regulation necessary to serve the statute's objectives, as is shown by its recent action to which we now turn.

E. The Recent Commission Report

On November 4, 1974, the Commission released its staff report entitled *"Mutual Fund Distribution and Section 22(d) of the Investment Company Act."* This, in turn, was followed by a Commission letter of November 22, 1974, to the NASD designed to implement a recommendation as to brokerage transactions contained in the report.

The letter pointed out that "although the Rules of Fair Practice do not require that agreements between fund underwriters and broker-dealers contain such requirements", the Commission was requesting the NASD to amend its rules "to prohibit its members from being parties to agreements which restrict broker-dealers, acting as agents, from matching orders to buy and sell fund shares in a secondary market at competitively determined prices and commission rates." The Commission observed that "it believes that sound regulatory policy dictates the elimination of any such restrictions". The staff report had pointed out that if the NASD declined to amend its rules, the Commission could effect the same result by acting under Section 22 (f) of the Act or Section 15 (c) (2) of the Securities Exchange Act of 1934 (p. 105, note 1).[90]

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[90] Section 15 (c) (2) authorizes the Commission to adopt rules to prevent any fradulent, deceptive, or manipulative act or practice, or the making of any fictitious quotation.

The staff report in making the recommendation for "matched orders" had pointed out (p. 105) that "[w]hile it is difficult to predict the actual impact of a *limited* secondary brokered market for fund shares, we do not believe it would disrupt the primary distribution system", which as already pointed out, is the statute's concern. Because of this consideration the staff did not recommend a conventional brokerage market, nor is it contemplated by the Commission.

Thus, in its letter to the NASD, the Commission pointed out that "action in this area should also include steps to help neutralize any adverse impact on the fund's primary distribution system and to ensure that transactions in a brokerage market are in the interest of all the holders of the funds outstanding shares." To this end, the Commission, as the staff report had recommended, proposes to introduce innovation and restraint.

A novel fee will be permitted. The Commission stated that "funds would be permitted to impose reasonable service fees when ownership of their shares is transferred in this manner [i.e., through order matching]. In the absence of any underwriters' spread on the sale, such fees could include the cost of recording the transfer as well as an amount to compensate the underwriter, to some extent, for promotional purposes." In this regard the staff report had pointed out that "persons who buy and sell shares in the secondary market do benefit indirectly from the underwriter's services, for example, advertising, in that the underwriter helps to create the continuous demand which is basic to the functioning of such a market. Therefore, they should help pay the cost of such services" (p. 106, note 1).

Next, the Commission imposed a trading restriction. It stated: "To ensure that broker-dealers engage only in genuine matching of orders, they should not be permitted to fill orders to buy or sell fund shares more than one full business day after such orders are received." The staff re-

port characterized this as a "safeguard against the secondary brokered market functioning like a dealer market" (p. 107), and added that if necessary appropriate rules in this regard could be adopted by the Commission (p. 107, note 2).

Lastly, the Commission observed: "Nor should broker-dealers be required to set up special procedures to match orders for fund shares". The matter is wholly voluntary.

The staff report also observed that if a Commission rule under Section 22 (f) proved necessary to remove the contractual restrictions, it should contain a provision to exempt a fund that could show that the secondary brokered market presented a significant threat to its primary distribution system (p. 108).

The Commission's approach is, of course, completely at odds with the major premise of appellant's hypothesis. Appellant denies the statute's concern with the protection of the primary distribution system from the secondary market. To the Commission it is a central theme not only in the brokerage market, but also in the dealer market, where it did not require any contractual changes. There too, however, the Commission staff report, in addressing itself to possible future changes and legislative proposals, expressed its concern about protecting the primary distribution system (pp. 118-119).

The Commission's action proceeds from the premise of the propriety of contractual restrictions in sales agreements and its regulatory authority over these agreements. The Commission's action also demonstrates that the flat termination of these restrictions, which appellant urges under the antitrust laws, would contravene the policy of the Investment Company. Act. If contractual restrictions are to be eliminated, that statute, in the Commission's view, requires circumscription and continuing administrative oversight. The Commission's action is eloquent testimony to

the fact that the matter at hand is not one for resolution under the antitrust laws. There is present the "prerequisite conflict between the regulatory and antitrust schemes", which appellant states must be found (Br. 58). While the Commission has taken action that is hospitable to some competition, it has not tailored that action with competition alone in mind, as the antitrust laws would dictate. The Commission has tempered its action to meet a statutory objective, which is by its nature anticompetitive and alien to the antitrust laws.

Appellant's approach is thus simply an assault on the statutory regulatory plan and policy which contradicts the antitrust laws. As regards the Commission's authority to achieve and implement the statutory policy, the Investment Company Act suffers from no deficiency. We shall leave that articulation to the Commission for the brief which it is filing. What was intended, the Commission can accomplish. The statute is adequate to its task. The only question that need be decided here is whether the Congress intended that the antitrust laws apply to mutual fund sales charges. As shown earlier, this was not its intention.

CONCLUSION

For the reasons stated, the judgment of the district court dismissing the complaint should be affirmed.

Respectfully submitted,

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APPENDIX A

Section 15A of the Securities Exchange Act of 1934

Section 15A. (a) Any association of brokers or dealers may be registered with the Commission as a national securities association pursuant to subsection (b), or as an affiliated securities association pursuant to subsection (d), under the terms and conditions hereinafter provided in this section, by filing with the Commission a registration statement in such form as the Commission may prescribe, setting forth the information, and accompanied by the documents, below specified:

(1) Such data as to its organization, membership, and rules of procedure, and such other information as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors; and

(2) Copies of its constitution, charter, or articles of incorporation or association, with all amendments thereto, and of its existing bylaws, and of any rules or instruments corresponding to the foregoing, whatever the name, hereinafter in this title collectively referred to as the "rules of the association."

Such registration shall not be construed as a waiver by such association or any member thereof of any constitutional right or of any right to contest the validity of any rule or regulation of the Commission under this title.

(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that—

(1) by reason of the number of its members, the scope of their transactions, and the geographical distribution of its members such association will be able to comply with the provisions of this title and the rules and regulations thereunder and to carry out the purposes of this section.

(2) such association is so organized and is of such a character as to be able to comply with the provisions of this title and the rules and regulations thereunder, and to carry out the purposes of this section.

(3) the rules of the association provide that any broker or dealer who makes use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, may become a member of such association, except such as are excluded pursuant to paragraph (4) or (5) of this subsection, or a rule of the association permitted under this paragraph. The rules of the association may restrict membership in such association on such specified geographical basis, or on such specified basis relating to the type of business done by its members, or on such other specified and appropriate basis, as appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purpose of this section. Rules adopted by the association may provide that the association may, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, deny admission to or refuse to continue in such association any broker or dealer if—

(A) such broker or dealer, whether prior or subsequent to becoming such, or

(B) any person associated with such broker or dealer, whether prior or subsequent to becoming so associated,

has been and is suspended or expelled from a national securities exchange or has been and is barred or suspended from being associated with all members of such exchange, for violation of any rule of such exchange.

(4) the rules of the association provide that, except with the approval or at the direction of the Commission

in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued in membership in such association, if such broker or dealer—

(A) has been and is suspended or expelled from a registered securities association (whether national or affiliated) or from a national securities exchange or has been and is barred or suspended from being associated with all members of such association or from being associated with all brokers or dealers which are members of such exchange, for violation of any rule of such association or exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade.

(B) is subject to an order of the Commission denying, suspending for a period not exceeding twelve months, or revoking his registration pursuant to section 15 of this title, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or barring or suspending him from being associated with a broker or dealer.

(C) whether prior or subsequent to becoming a broker or dealer, by his conduct while associated with a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such broker or dealer, and in entering such a suspension, expulsion, or order, the Commission or any such exchange or association shall have jurisdiction to determine whether or not any person was a cause thereof.

(D) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person who, if such person were

a broker or dealer, would be ineligible for admission to or continuance in membership under clause (A), (B), or (C) of this paragraph.

(5) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no person shall become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such other qualifications of such person as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such member. For the purpose of defining such standards and the application thereof, such rules may—

(A) appropriately classify prospective members (taking into account relevant matters, including type of business done and nature of securities sold) and persons proposed to be associated with members.

(B) specify that all or any portion of such standards shall be applicable to any such class.

(C) require persons in any such class to pass examinations prescribed in accordance with such rules.

(D) provide that persons in any such class other than prospective members and partners, officers and supervisory employees (which latter term may be defined by such rules and as so defined shall include branch managers of members) of members, may be qualified solely on the basis of compliance with specified standards of training and such other qualifications as the association finds appropriate.

(E) provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to the

training, experience, and other qualifications (including, in the case of an applicant for membership, financial responsibility) of the applicant and that the association may adopt procedures for verification of qualifications of the applicant.

(F) require any class of persons associated with a member to be registered with the association in accordance with procedures specified by such rules (and any application or document supplemental thereto required by such rules of a person seeking to be registered with such association shall, for the purposes of subsection (a) of section 32 of this title, be deemed an application required to be filed under this title).

(6) the rules of the association assure a fair representation of its members in the adoption of any rule of the association or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs.

(7) the rules of the association provide for the equitable allocation of dues among its members, to defray reasonable expenses of administration.

(8) the rules of the association are designed to prevent fradulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

(9) the rules of the association provide that its members and persons associated with its members shall be

appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules.

(10) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member. In any proceeding to determine whether any member or other person shall be disciplined, such rules shall require that specific charges be brought; that such member or person shall be notified of, and be given an opportunity to defend against, such charges; that a record shall be kept; and that the determination shall include—

(A) a statement setting forth any act or practice in which such member or other person may be found to have engaged, or which such member or other person may be found to have omitted.

(B) a statement setting forth the specific rule or rules of the association of which any such act or practice, or omission to act, is deemed to be in violation.

(C) a statement whether the acts or practices prohibited by such rule or rules, or the omission of any act required thereby, are deemed to constitute conduct inconsistent with just and equitable principles of trade.

(D) a statment setting forth the penalty imposed.

In any proceeding to determine whether a broker or dealer shall be denied membership or whether any person shall be barred from being associated with a member, such rules shall provide that the broker or dealer or person shall be notified of, and be given an opportunity to be heard upon, the specific grounds for denial or bar which are under consideration; that a record shall be kept; and that the determination shall set forth the specific grounds upon which the denial or bar is based.

(11) the requirements of subsection (c), insofar as these may be applicable, are satisfied.

(12) the rules of the association include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be disseminated by any member or any person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations.

The provisions of this subsection, as in effect prior to the date of enactment of the Securities Acts Amendments of 1964, shall be applicable to the rules of any registered securities association which was registered on such date until July 1, 1964. After July 1, 1964, the Commission may, after notice and opportunity for hearing, suspend the registration of any such association if it finds that the rules thereof do not conform to the requirements of this subsection, as amended by section 7 of the Securities Acts Amendments of 1964, and any such suspension shall remain in effect until the Commission issues an order determining that such rules have been modified to conform with such requirements.

(c) The Commission may permit or require the rules of an association applying for registration pursuant to subsection (b), to provide for the admission of an association registered as an affiliated securities association, pursuant to subsection (d) to participation in said applicant association as an affiliate thereof, under terms permitting such power and responsibilities to such affiliates, and under such other appropriate terms and conditions, as may be provided by the rules of said applicant association, if such rules appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purposes of this section. The duties and

powers of the Commission with respect to any national securities association or any affiliated securities association shall in no way be limited by reason of any such affiliation.

(d) An applicant association shall not be registered as an affiliated securities association unless it appears to the Commission that—

(1) such association, notwithstanding that it does not satisfy the requirements set forth in paragraph (1) of subsection (b), will, forthwith upon the registration thereof, be admitted to affiliation with an association registered as a national securities association pursuant to said subsection (b), in the manner and under the terms and conditions provided by the rules of said national securities association in accordance with subsection (c); and

(2) such association and its rules satisfy the requirements set forth in paragraphs (2) to (10), inclusive, and paragraph (12), of subsection (b); except that in the case of any such association any restrictions upon membership therein of the type authorized by paragraph (3) of subsection (b) shall not be less stringent than in the case of the national securities association with which such association is to be affiliated.

(e) Upon the filing of an application for registration pursuant to subsection (b) or subsection (d), the Commission shall by order grant such registration if the requirements of this section are satisfied. If, after appropriate notice and opportunity for hearing, it appears to the Commission that any requirement of this section is not satisfied, the Commission shall by order deny such registration. If any association granted registration as an affiliated securities association pursuant to subsection (d) shall fail to be admitted promptly thereafter to affiliation with a registered national securities association, the Commission shall revoke the registration of such affiliated securities association.

(f) A registered securities association (whether national or affiliated) may, upon such reasonable notice as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing with the Commission a written notice of withdrawal in such form as the Commission may by rules and regulations prescribe. Upon the withdrawal of a national securities association from registration, the registration of any association affiliated therewith shall automatically terminate.

(g) If any registered securities association (whether national or affiliated) takes any disciplinary action against any member thereof or any person associated with such a member or denies admission to any broker or dealer seeking membership therein, or bars any person from being associated with a member, such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after such action has been taken or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall operate as a stay of such action until an order is issued upon such review pursuant to subsection (h), unless the Commission otherwise orders after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of affidavits and oral arguments).

(h) (1) In a proceeding to review disciplinary action taken by a registered securities association against a member thereof or a person associated with a member, if the Commission, after appropriate notice and opportunity for hearing, upon consideration of the record before the association and such other evidence as it may deem relevant—

(A) finds that such member or person has engaged in such acts or practices, or has omitted such act, as the

association has found him to have engaged in or omitted, and

(B) determines that such acts or practices, or omission to act, are in violation of such rules of the association as have been designated in the determination of the association,

the Commission shall by order dismiss the proceeding, unless it appears to the Commission that such action should be modified in accordance with paragraph (2) of this subsection. The Commission shall likewise determine whether the acts or practices prohibited, or the omission of any act required, by any such rule constitute conduct inconsistent with just and equitable principles of trade, and shall so declare. If it appears to the Commission that the evidence does not warrant the finding required in clause (A), or if the Commission determines that such acts or practices as are found to have been engaged in are not prohibited by the designated rule or rules of the association, or that such act as is found to have been omitted is not required by such designated rule or rules, the Commission shall by order set aside the action of the association.

(2) If, after appropriate notice and opportunity for hearing, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

(3) In any proceeding to review the denial of membership in a registered securities association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing, and upon consideration of the record before the association and such other evidence as it may deem relevant, determines that the specific grounds on which such denial or bar is based exist in fact and are valid under this section, the Commission shall by order dismiss the proceeding; other-

wise, the Commission shall by order set aside the action of the association and require it to admit the applicant broker or dealer to membership therein, or to permit such person to be associated with a member.

(i) (1) The rules of a registered securities association may provide that no member thereof shall deal with any nonmember broker or dealer (as defined in paragraph (2) of this subsection) except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

(2) For the purposes of this subsection, the term "nonmember broker or dealer" shall include any broker or dealer who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, who is not a member of any registered securities association, except a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, or commercial bills.

(3) Nothing in this subsection shall be so construed or applied as to prevent any member of a registered securities association from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms.

(j) Every registered securities association shall file with the Commission in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, copies of any changes in or additions to the rules of the association, and such other information and documents as the Commission may require to keep current or to supplement the registration statement and documents filed pursuant to subsection (a). Any change in or addition to the rules of a registered securities association shall take effect upon the thirtieth day after the filing of a copy

thereof with the Commission, or upon such earlier date as the Commission may determine, unless the Commission shall enter an order disapproving such change or addition; and the Commission shall enter such an order unless such change or addition appears to the Commission to be consistent with the requirements of subsection (b) and subsection (d).

(k) (1) The Commission is authorized by order to abrogate any rule of a registered securities association, if after appropriate notice and opportunity for hearing, it appears to the Commission that such abrogation is necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this title.

(2) The Commission may in writing request any registered securities association to adopt any specified alteration of or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modifications of such alteration or supplement as it deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section, with respect to—

(A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof.

(B) the method for adoption of any change in or addition to the rules of the association.

(C) the method of choosing officers and directors.

(D) affiliation between registered securities associations.

(l) The Commission is authorized, if such action appears to it to be necessary or appropriate in the public interest or for the protection of investors or to carry out the purposes of this section—

(1) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to revoke the registration of a registered securities association, if the Commission finds that such association has violated any provision of this title or any rule or regulation thereunder, or has failed to enforce compliance with its own rules, or has engaged in any other activity tending to defeat the purposes of this section.

(2) after appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a registered securities association any member thereof, or to suspend for a period not exceeding twelve months or to bar any person from being associated with a member thereof, if the Commission finds that such member or person—

(A) has violated any provision of this title or any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe, was violating with respect to such transaction any provision of this title or any rule or regulation thereunder.

(B) has willfully violated any provision of the Securities Act of 1933, as amended, or of any rule or regulation thereunder, or has effected any transaction for any other person who, he had reason to believe,

was willfully violating with respect to such transaction any provision of such Act or rule or regulation.

(3) after appropriate notice and opportunity for hearing, by order to remove from office any officer or director of a registered securities association who, the Commission finds, has willfully failed to enforce the rules of the association, or has willfully abused his authority.

(m) Nothing in this section shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security.

(n) If any provision of this section is in conflict with any provision of any law of the United States in force on the date this section takes effect, the provision of this section shall prevail.

APPENDIX B

Pertinent Provisions of Section 22 of the Investment Company Act

Section 22. (a) A securities association registered under section 15A of the Securities Exchange Act of 1934 may prescribe, by rules adopted and in effect in accordance with said section and subject to all provisions of said section applicable to the rules of such an association—

(1) a method or methods for computing the minimum price at which a member thereof may purchase from any investment company any redeemable security issued by such company and the maximum price at which a member may sell to such company any redeemable security issued by it or which he may receive for such security upon redemption, so that the price in each case will bear such relation to the current net asset value of such security computed as of such time as the rules may prescribe; and

(2) a minimum period of time which must elapse after the sale or issue of such security before any resale to such company by a member or its redemption upon surrender by a member;

in each case for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities; and said rules may prohibit the members of the association from purchasing, selling, or surrendering for redemption any such redeemable securities in contravention of said rules.

(b) (1) Such a securities association may also, by rules adopted and in effect in accordance with said section 15A, and notwithstanding the provisions of subsection (b) (8) thereof but subject to all other provisions of said section applicable to the rules of such an association, prohibit its

members from purchasing, in connection with a primary distribution of redeemable securities which any registered investment company is the issuer, any such security from the issuer or from any principal underwriter except at a price equal to the price at which such security is then offered to the public less a commission, discount, or spread which is computed in conformity with a method or methods, and within such limitations as to the relation thereof to said public offering price, as such rules may prescribe in order that the price at which such security is offered or sold to the public shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors. The Commission shall on application or otherwise, if it appears that smaller companies are subject to relatively higher operating costs, make due allowance therefor by granting any such company or class of companies appropriate qualified exemptions from the provisions of this section.

(2) At any time after the expiration of eighteen months from the date of enactment of the Investment Company Amendments Act of 1970, or after a securities association has adopted rules as contemplated by this subsection, the Commission may make such rules and regulations pursuant to section 15 (b) (10) of the Securities Exchange Act of 1934 as are appropriate to effectuate the purpose of this subsection with respect to sales of shares of a registered investment company by broker-dealers subject to regulation under section 15 (b) (8) of that Act: *Provided,* That the underwriter of such shares may file with the Commission at any time a notice of election to comply with the rules prescribed pursuant to this subsection by a national securities association specified in such notice, and thereafter the sales load shall not exceed that prescribed by such rules of such association, and the rules of the Commission as hereinabove authorized shall thereafter be inapplicable to such sales.

(3) At any time after the expiration of eighteen months from the date of enactment of the Investment Company Amendments Act of 1970 (or, if earlier, after a securities association has adopted for purposes of paragraph (1) any rule respecting excessive sales loads), the Commission may alter or supplement the rules of any securities association as may be necessary to effectuate the purposes of this subsection in the manner provided by section 15A (k) (2) of the Securities Exchange Act of 1934.

(4) If any provision of this subsection is in conflict with any provision of any law of the United States in effect on the date this subsection takes effect, the provisions of this subsection shall prevail.

(c) The Commission may make rules and regulations applicable to registered investment companies and to principal underwriters of, and dealers in, the redeemable securities of any registered investment company, whether or not members of any securities association, to the same extent, covering the same subject matter, and for the accomplishment of the same ends as are prescribed in subsection (a) of this section in respect of the rules which may be made by a registered securities association governing its members. Any rules and regulations so made by the Commission, to the extent that they may be inconsistent with the rules of any such association, shall so long as they remain in force supersede the rules of the association and be binding upon its members as well as all other underwriters and dealers to whom they may be applicable.

(d) No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such

contain among its provisions such of the other requirements of this rule as the parties may deem pertinent or appropriate, but the failure so to include any such other requirement shall not exempt any transaction from the effect of this rule or any part thereof.

* * *

Withhold orders

(f) (1) No member shall withhold placing customers' orders for any such security so as to profit himself as a result of such withholding.

Purchase for existing orders

(2) No member shall purchase the securities of any open-end investment company of which it is the underwriter from such company except for the purpose of covering purchase orders already received and no member shall purchase such securities from the underwriter other than for investment except for the purpose of covering purchase orders already received.

* * *